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# NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



## DTIC QUALITY INSPECTED 4 THESIS

**SURVIVOR BENEFIT PLAN:  
AN ANALYSIS OF DIRECT REMITTANCES  
DIVERTED TO THE U.S. TREASURY**

Andrew W. Hovanec

December, 1995

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Survivor Benefit Plan: An Analysis  
of Direct Remittances Diverted to the U.S. Treasury

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Submitted in partial fulfillment  
of the requirements for the degree of

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from the

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## **ABSTRACT**

The Survivor Benefit Plan is a voluntary program designed to provide income protection for dependent survivors of members of the armed forces who die in retirement or while on active duty after reaching retirement eligibility. Obligations of the Federal government to survivors, arising under the Survivor Benefit Plan, are paid from the Military Retirement Fund. United States Code Title 10, § 1452 requires persons participating in the Plan, and not entitled to retired pay, to deposit premium payments in the U.S. Treasury vice the Military Retirement Fund. The member is required to pay premiums due to the Plan through a process called direct remittance. This thesis determined the annual amount of direct remittances arising from the Survivor Benefit Plan, and analyzed the financial loss to the Military Retirement Fund due to the diversion of these funds to the U.S. Treasury. An understanding of this process and the unique problems that direct remittances represent provides a valuable contribution to understanding the accounting and valuation process of the Military Retirement Fund.





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## **I. INTRODUCTION**

### **A. BACKGROUND**

Congress created the survivor's benefits program within the Military Retirement System (MRS) in 1953 to provide an improved program of income protection for survivors of retired and retirement-eligible members of the uniformed services. The purpose of this program is to provide survivors of military personnel who die on active duty or after retirement eligibility with a reasonable level of income. The Survivor's Benefit Plan (SBP) is one such program designed for military retirees to provide an annuity to eligible survivors.

SBP is a voluntary program in which a military retiree may elect to receive a reduced amount of retired pay to provide a annuity of up to 55 percent of the deceased member's gross retired pay. Each servicemember with dependents is automatically enrolled, at the time of retirement, into the plan unless the member specifically elects before retirement not to be covered or to be covered at less than the maximum level.

Retirees electing SBP are required to pay a monthly premium for coverage. Most retirees elect premiums to be deducted from their gross pay through the payroll deduction plan. Payroll deductions for SBP costs remain in the Military Retirement Fund (MRF) since this is the same trust fund from which survivors will be paid an annuity upon the servicemember's death. Some military retirees do not receive retired pay from the MRF because they are receiving benefits from the Department of Veterans Affairs (VA), or have continued employment in the Civil Service sector which mandates an offset to their retired pay. Retirees in these cases submit personal checks, money orders and etc., or have payments

deducted and remitted by the VA for their survivor benefit premiums. These types of SBP cost payments are determined to be "direct remittances", and are consequently deposited into a U.S. Treasury receipt account vice the Military Retirement Fund.<sup>1</sup> The result is the diversion of SBP cost payments into a Treasury account and a loss in valuation to the MRF.

While the Survivor Benefit Plan is not a highly visible component of the Military Retirement Fund and funding process, the Retiree and Annuitant Pay section, of the Defense Finance and Accounting Service (DFAS) has been directly concerned about the diversion of these premiums and benefit to the U.S. Treasury while the Military Retirement Fund suffers a loss. By necessity, all Department of Defense (DoD) agencies have become extremely cost conscious, and concerned with accounting practices and funding shortfalls. Because of this, the DoD and taxpayers can not afford to pay more than it has to for any program, including the Survivor Benefit Plan. An understanding of this program and the unique problem that direct remittances present will provide another window into understanding the workings and valuation process of the Military Retirement Fund.

## **B. OBJECTIVES**

The purpose of this thesis is to describe and critique the accounting practices for direct remitted SBP premiums, and determine the impact of their diversion on future funding and the fiscal integrity of the Military Retirement Fund. A brief history of the SBP program within the military retirement system, and its relationship with the Military Retirement Fund will be presented. Armed Forces public law Title 10 U.S.C., section 1452(d) requiring direct

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<sup>1</sup>"direct remittances" in this case refers to any type of payment other than payment as a result of payroll deduction.

remittances from SBP participants to be deposited into a U.S. Treasury account vice the Military Retirement Fund will be reviewed. In addition, the valuation strategy developed by the Department of Defense Office of Actuary in determining unfunded liabilities to pay future retirement costs will be described. This paper will attempt to gain an understanding of problems and concerns by the Defense Finance and Accounting Service, Retiree and Annuitant Pay branch, as a result of the diversion of direct remittances from the Military Retirement Fund.

### **C. THE RESEARCH QUESTION**

The primary research question is this: "What amount of SBP premiums do direct remittances represent which are currently being deposited into the U.S. Treasury vice the Military Retirement Fund, and is this amount significant enough to cause unfunded liabilities to the MRF long term?" Subsidiary questions to be addressed include:

1. What are the statutory requirements of Title 10 U.S.C., section 1452(d)?
2. Concerning direct remittances, what is the interpretation of public law Title 10 U.S.C., 1452 (d) as addressed by DFAS?
3. Why are VA benefits awarded to military retirees and used for SBP premiums considered direct remittances?
4. How does DFAS account for direct remittances?
5. What, if any, additional costs would be incurred by DFAS to properly account for and ensure direct remitted funds are transferred to the MRF?
6. What are the statutory requirements governing the management and operation of the DoD Military Retirement Fund?

7. What actions have been taken by the DoD Office of Actuary in considering the diversion of direct remittances from the MRF and the subsequent under valuation of this trust fund?

#### **D. SCOPE, LIMITATIONS, AND ASSUMPTIONS**

The focus of this thesis will be on the mechanics of the accounting and reporting of direct remittances by DFAS to the U. S. Treasury. Included will be descriptive information on the operation of the SBP program and the Military Retirement Fund. Special attention is given to the diversion of direct remitted SBP premiums to the U.S. Treasury and the subsequent unfunded liability to the MRF.

Data used in numerical presentations will be limited to FY 1995 and earlier due to the time lag in source document publication. Information related to the unfunded liability of the Military Retirement Fund will be drawn from documents available in FY 1994 and earlier.

#### **E. METHODOLOGY**

This thesis is based on an examination of data generated by the Defense Manpower Data Center and Defense Finance and Accounting Service, studies and reports produced by the Department of Defense Office of the Actuary, the Congressional Budget Office and other government offices, e.g., the General Accounting Office. Examination of federal legislature including statutory law and congressional reports, hearings and other scholarly materials such as books that address the subject of Survivors Benefit Plan and budgeting for military retirement were all reviewed for research documentation. Supplementary data and information was obtained through interviews with personnel of DoD and other government offices.



## **F. DEFINITIONS AND ABBREVIATIONS**

The following list of acronyms, abbreviations and definitions are provided in the interests of clarification.

1. Military Retirement System (MRS) - MRS is an acronym which refers collectively to nondisability retired pay, disability retired pay, retired pay for reserve service, survivor annuity programs and associated benefits.

2. Military Retirement Fund (MRF or Fund) - The Fund, or MRF is a term used to refer to the federal trust fund administered by the Secretary of the Treasury which accumulates resources in order to finance liabilities of the DoD under military retirement programs and survivor benefit programs.

3. Survivor Benefit Plan (SBP) - SBP is a program designed to provide income protection for dependent survivors of servicemembers who die in retirement or while on active duty after reaching eligibility. [Ref. 1: p. I-1]

4. Annuities - Annuities are defined, herein, as monthly government disbursements that provide partial income replacement for dependent survivors of active duty and retired Service personnel.

5. Defense Finance and Accounting Service (DFAS) - DFAS was established in January 1991, as the agency responsible for consolidating and standardizing all financing and accounting systems throughout DoD.

6. Unfunded Liabilities - Unfunded liabilities represent the future claims of military retirees and /or their survivors on assets which do not currently exist within a trust fund. These liabilities are designated as unfunded. [Ref. 2: p. 6]

## **G. ORGANIZATION OF STUDY**

This thesis is divided into six chapters presented as follows:

- 1. Chapter I: INTRODUCTION**
- 2. Chapter II: THE ESTABLISHMENT OF THE SURVIVOR BENEFIT PLAN**

This chapter describes the legislative history of the Survivor Benefit Plan. The congressional perception of the Survivor Benefit Plan and circumstances which compel the need for this program are examined.

- 3. Chapter III: THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND: RELATIONSHIP OF SBP PROGRAM TO TRUST FUND**

This chapter describes the legislative and funding history of the Military Retirement Fund and the method by which Congress appropriates funds for this trust fund. The relationship of the SBP program to the Military Retirement Fund will be presented. An outline of the responsibilities of the Defense Finance and Accounting Service and the DoD Office of the Actuary in administering this Fund will be explained.

- 4. Chapter IV: THE DIVERSION OF SBP PREMIUMS: ANALYSIS OF DIRECT REMITTANCES DEPOSITED INTO THE U.S. TREASURY**

This chapter defines and examines the statutory requirements and mechanics for accounting of direct remittances submitted as Survivor Benefit premiums. An analysis of direct remitted data and the subsequent diversion of these funds to the U.S. Treasury will be examined. In addition, this chapter describes the impact and consequences of diverting assets from the Military Retirement Fund.

**5. Chapter V: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

This chapter summarizes the findings and analysis presented, and makes recommendations for the management of the Military Retirement Fund.



## **II. THE ESTABLISHMENT OF THE SURVIVOR BENEFIT PLAN**

### **A. INTRODUCTION**

Prior to 1953 there was no program available to the military services to provide financial benefits to survivors of retired military personnel. The only benefits to which survivors could become entitled were provided under the Dependency and Indemnity Compensation (DIC) program administered by the Veterans Administration (VA). These benefits were provided only to survivors of retirees who died as a result of service connected injuries or illness. Survivors of military retirees who died of non-service connected causes received no compensation from the military services when their spouses passed away [Ref. 3: p. 12-1]. To remedy this condition, Congress enacted a series of laws over the years to provide appropriate benefits to survivors of active duty and military retirees. This chapter will explore the legislative evolution of the Survivors Benefit Plan, and describe the various components of this program. In addition, an examination of defined benefits versus contributions, and member participation costs and service participation rates will also be reviewed.

### **B. HISTORICAL BACKGROUND**

The forerunner to the SBP was the Uniformed Services Contingency Option Act of 1953 which was the first law to allow servicemembers to elect a reduced amount of retired pay during their retirement years in order to provide their surviving dependents with a continuing annuity after the member's death. To provide such an annuity, the Contingency

Option Plan was structured on an actuarial-equivalent, un-subsidized basis. Thus, a servicemember's participation cost was established on age, disability/non-disability status, and the age of his/her dependents at the time of retirement. Because of the un-subsidized aspect of the program, a retiree could expect a relatively high cost in monthly premiums. A representative monthly member cost for this plan was 22.8 cents per dollar of the monthly retirement annuity. [Ref. 1: p. IV-1]

#### **1. The Uniformed Services Contingency Option Act**

The original plan established a survivor annuity option of one-half, one-fourth, or one-eighth of the member's retired pay at the time of retirement, as reduced by the participation cost. Election to participate in the plan had to be executed prior to the start of the member's 18th year of service and any change to, or revocation, of the original participation option required the member to remain on active duty for five years after change or revocation. This participation election criteria was not well received in that it required the member to enter into a long term commitment while still two to 12 years from actual retirement. Thus, this plan required the member to make a very important and lasting financial decision impacting on the future well being of the member and his/her dependents with only very rudimentary information as to what participation cost and annuity amount would actually be at the time of retirement. In addition, since the plan offered no inflation protection for the survivor's annuity (the annuity was frozen at the level computed at the date of the member's retirement) the plan was viewed with further skepticism as to its real future worth. This situation, coupled with the fact that the member's participation cost was subject to taxation and,

therefore, required the payment of taxes on monies not yet received, served to further discourage member participation in the plan. [Ref. 1: p. IV-1]

## **2. The Retired Serviceman's Family Protection Plan**

The Uniformed Services Contingency Option Plan proved to be expensive and inadequate since the survivor's annuities were never adjusted for inflation and could not be more than 50% of retired pay. Public law 87-381 (1961) changed the name of the Contingency Option Plan to the Retired Serviceman's Family Protection Plan (RSFPP). In doing so, Congress included changes within this law to primarily: (1) make the program's election procedures more flexible; (2) allow a member to execute an option to participate subsequent to the 18th year of service provided the member remained on active duty a minimum of three years after election; and, (3) reduce the amount of subsequent active duty required after initiating a change or revocation action to the original election option from five years to three. While these changes did liberalize the plan somewhat, the self-supporting basis resulted in an increase in the member's participation cost. A representative monthly participation cost was now 25.3 (vice 22.8) cents per dollar of monthly annuity coverage; an increase of 11 percent compared to the Contingency Option Plan. [Ref. 1: p. IV-2]

In a further effort to attain greater participation and interest in the plan, additional liberalization of various provisions of RSFPP by Congress occurred from 1961 through 1972.<sup>2</sup> Although this liberalization effort made rather sweeping changes, the cost to the

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<sup>2</sup>This paper will not examine every legislative change concerning this program. The reader is provided a summary outlining the laws from 1953 to 1991 in the Appendix.

member again increased significantly and little increase in participation resulted. The representative monthly participation cost from this liberalization effort rose to 42.9 (vice 25.3) cents per dollar of monthly annuity coverage; an increase of 70 percent. Even after several revisions neither the Contingency Option Act nor the Retired Servicemen's Family Protection Plan ever achieved a participation rate of more than 15 percent of the retired members. [Ref. 1: p. IV-2]

### **C. SURVIVOR BENEFIT PLAN**

Determined to provide superior participation coverage, Congress enacted Public Law 92-425 on 21 September 1972, and RSFPP was terminated and replaced by the Survivor Benefit Plan. New retirees, as of this date, were automatically enrolled into SBP while those servicemen retired before 1972 were given the option of converting to SBP or maintaining their RSFPP. It should be noted, RSFPP still exists today for those who did not convert and still pays survivor annuities.

A number of changes have taken place since 1972, so SBP will only be discussed by delineating the major provisions set forth by Public Law 92-425. The reader is encouraged to review the Appendix for the changes to SBP as they occurred chronologically.

#### **1. Major Provisions of Survivor Benefit Plan**

Public Law 92-245 authorized SBP participation to all retired members of the Armed Forces, including the U.S. Coast Guard (USCG), Public Health Service (PHS), and the National Oceanic and Atmospheric Administration (NOAA). Service members retiring under the 15-year early retirement program are also eligible to enroll in the SBP program.



Retirement-eligible members of the above services who are serving on active duty are covered by SBP at the maximum level as long as they remain on active duty. In other words, members who die on active duty with over 20 years of military service are assumed to have retired on the day they died and to have elected full SBP coverage for spouses and/or children.

*a. Automatic Enrollment and Base Amount*

Upon retirement, enrollment in SBP with the maximum level of coverage is automatic for all members unless a member elects to decline participation or to participate with a reduced "base amount"<sup>3</sup> prior to the date on which the member becomes entitled to retired pay. Written concurrence from the member's spouse is required to decline participation or to elect a reduced level of coverage for spouse only, spouse and child(ren) only options [Ref. 4: p. 122]. If the member's spouse does not concur with the election, the law requires that a retiree be enrolled in SBP at the maximum level. This law applies to all pension survivorship plans in the United States, not just SBP.

The SBP survivor annuity is initially 55 percent of the member's base amount. A base amount may be any amount elected by the member, but cannot be less than \$300 or more than the member's full retired pay. For example, a retired O-5 with 20 years of service is entitled to retired pay in the amount of \$2,349 (at 1995 pay levels) per month, and could

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<sup>3</sup>A member's "base amount" is an amount selected by a participant at the time of enrollment on which the member's monthly premium and the survivor's monthly annuity will be computed.

elect \$1,000 as the base amount for SBP coverage, if so desired. Thus, the beneficiary's monthly annuity would be \$550 ( $.55 \times 1,000 = 550$ ).

***b. Social Security Offset***

An SBP annuitant is guaranteed to receive 55 percent of the participant's base amount until age 62, when it is reduced to 35 percent of the base amount. This reduction is due to the surviving spouse's entitlement to Social Security survivor benefits attributable to the member's income while serving on active duty. Often referred to as the "two-tier" benefit, this offset (reduction in SBP) is applied to surviving spouses at age 62 whether an annuitant's social security benefit is based completely or partially on his/her own social security wage record, or on the social security wage record of his/her military spouse.

Prior to the enactment of the two-tier method, the survivor annuity was fully integrated with Social Security. As such, the Social Security offset to SBP was based on the Social Security credit earned by the participant while on active duty. Increases in Social Security benefits during the 1970s, however, resulted in larger offsets to SBP annuities than originally intended. Thus, a limit was placed on the Social Security offset to 40% of the SBP annuity. In order to increase benefits and reduce the administration burden involved with computing offsets, Congress eliminated this Social Security offset in November 1985 (P.L. 99-145) and replaced it with new two-tier method. Survivors of members who retired or were eligible for retirement before October 1, 1985 are grandfathered under the original Social Security offset method. Defense Finance and Accounting Service (DFAS) centers calculate annuities using both methods when an annuitant attains age 62 and pays the higher

amount. In most cases, survivor's receive higher annuities under the new two-tier method than under the original method. In summary, because the Federal Government pays part of the cost for both SBP and Social Security, SBP payments to a surviving spouse are offset by a certain amount of the Social Security benefit. [Ref. 4: pp. 123 & 128]

*c. Tax Treatment and Irrevocable Policy*

Of great importance to all retirees is that retired pay is reduced, before taxes, for the member's cost of SBP. Since SBP premiums are paid in the form of reductions in participant's retired pay, they are not counted as taxable income. This tax benefit is significant when comparing what SBP participation will really cost a retiree as compared to an alternative insurance plan. Further, once elected by a retiree, SBP is essentially, irrevocable. Changes are permitted, however, to accommodate common changes which could occur in family situations. Basically, if a member elects coverage for eligible family members when retirement occurs, the coverage will continue for as long as the beneficiary(s) remain eligible. If the member declines coverage for eligible family members, the retiree cannot later choose to enroll in SBP for that category of beneficiary. [Ref. 3: p. 11]

*d. Cost-of-Living Adjustments*

SBP premiums and survivor annuities are adjusted annually by the same percentage as military retired pay. Military retired pay is usually adjusted annually at the same rate as the annual increase in the Consumer Price Index (CPI) [Ref. 4: p. 129]. These cost-of-living adjustments (COLAs) may be based on full or partial CPI increases, depending on when the member first entered the Armed Services. This annual COLA adjustment is also a

significant advantage of SBP which is generally not offered by alternative insurance or estate planning programs.

*e. Veteran's Administration Benefit*

No doubt the most important Federal benefit that Congress has provided specifically for all veterans, their dependents and beneficiaries are Veterans Administration (VA) benefits. These benefits are usually in the form of a disability compensation for a service connected disability. This disability compensation means a monthly payment by the VA to a veteran as a result from disease or injury incurred in or aggravated during active duty or active duty for training. [Ref. 4: p. 143]

A retiree receiving retired pay who is also eligible to receive disability compensation/pension from the VA is barred from receiving concurrent payments of both retired pay and the VA benefit, unless the member elects to waive that portion of the the retired pay that is equal to the amount of the VA benefit awarded. Any retiree participating in RSFPP/SBP who waives retired pay in favor of VA benefits may authorize the VA to withhold the cost of the RSFPP and/or SBP from the benefits awarded and have that amount remitted directly to the cognizant retired pay activity [Ref. 5: pp. 3-1 & 3-3]. Or, the retiree may elect to remit the SBP premium directly by himself/herself to the appropriate Defense Finance center. SBP annuities paid to survivors, likewise, are reduced by VA survivor benefits (see Dependency and Indemnity Compensation below).

*f. Dependency and Indemnity Compensation*

Lastly, when a member of the Uniformed Services dies of a service-connected

cause, either while on active duty or in retirement, certain members of his or her family may be eligible for monthly Dependency and Indemnity Compensation (DIC) payments from the Veterans Administration (VA). Whenever a surviving spouse of an SBP participant is also entitled to DIC, the spouse's monthly SBP annuity will be reduced by the amount of the DIC payment. The total of the two payments, DIC and SBP, will be equal to the full amount of the SBP annuity. If the surviving spouse remarries and becomes ineligible for DIC, the full amount of SBP may be paid if the spouse is over age 55 when the remarriage occurs. When DIC is paid to the surviving spouse of an SBP participant, the percentage of the participant's SBP or premiums which corresponds to the portion of the SBP annuity not payable is refunded to the beneficiary. [Ref. 4: p. 129]

These major provisions of SBP listed above are the foundation of the program. As indicated, SBP premiums and survivor annuities are calculated as percentages of whatever base amount a retiree chooses. In addition, premiums and annuities will vary depending of the category of coverage selected.

## **2. Coverage Available**

There are five categories of beneficiaries that may be elected to receive survivor protection under SBP. The category elected determines the amounts of a member's premium and the survivors annuities. The categories available to a participant are as follows.

### ***a. Spouse Only***

Eligibility for this coverage requires that a surviving spouse be a widow or widower who was married to a retiree at the time of his or her retirement; or, if not married

at the time of retirement, was married to the deceased retiree for at least one year prior to his or her death; or, if not married at time of retirement and was not married to the deceased retiree for at least one year prior to his or her death, was the parent of a child born or adopted during the marriage to the retiree. SBP spouse coverage applies not only to the spouse a member has at time of enrollment, but also automatically to any future spouse the member might acquire, unless the member elects to decline coverage. [Ref. 4: p. 122]

***b. Spouse and Child(ren)***

With this option, SBP protection is expanded to cover an eligible child or children if there is no surviving spouse, or if a surviving spouse subsequently dies or becomes ineligible to receive benefits due to remarriage before the age of 55. [Ref. 4: p. 123]

***c. Child(ren) Only***

This option provides an annuity only for dependent children regardless of whether a member is married or not at time of enrollment (although a married member's spouse must concur with a child(ren) only election). Children remain beneficiaries until age 18 or age 22 if a full-time student. Children mentally or physically incapable of self-support remain eligible for as long as the incapacitation exists or until marriage. Children's annuities are calculated at 55% of the member's base amount for as long as the child(ren) remain eligible and are not reduced due to entitlement to any other Government benefits. The 55% annuity is divided equally among all eligible children. [Ref. 4: p. 123]

A retiree with no dependent children at time of retirement may elect coverage for a child subsequently acquired, but the child must be added within one year of being

acquired (i.e., born, adopted, etc). The member may not later elect coverage for children acquired after retirement if the member had children upon retirement and did not elect coverage. [Ref. 4: p. 123]

*d. Former Spouse/Former Spouse and Child(ren)*

Eligibility of former spouses is the same as for spouse-only coverage, and eligibility for former spouse and child(ren) is the same as for spouse and child(ren). The only exception is that the child(ren) acquired during the marriage to a former spouse may be included in a former spouse-and-child election. Children acquired after divorce cannot be included in a former spouse-and-child election. Further, a former spouse election after retirement cancels any previous election. [Ref. 3: p. 70]

*e. Persons with Insurable Interest*

This type of coverage is only available to members who are unmarried and have no more than one dependent child on their dates of retirement. Under this category of coverage, an unmarried retiree may name someone who has an "insurable interest"<sup>4</sup> in the retiree as a beneficiary. An unmarried retiree who has only one dependent child, however, may name that child as insurable interest rather than as a beneficiary under "child only". Insurable interest elections are permanent and irrevocable, although, they may be changed to a spouse and/or child election if a retiree later becomes married or acquires a dependent child. [Ref. 3: p. 76]

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<sup>4</sup>An "insurable interest" beneficiary is a person who has a financial interest in the continued life of a retiree. This can be either a non-related person or a family member.

### **3. Additional Coverage with Supplemental SBP**

As discussed earlier, the SBP annuity is calculated at 55% of the participant's base amount until age 62, when it is reduced to 35% of the base amount. Although the value of even this reduced level of benefits after age 62 is an excellent buy for the premium dollar, many retirees may want or need to provide higher amounts of income to their survivors after age 62. Members who elect maximum coverage under basic SBP may also enroll in Supplemental SBP to increase their survivor's post-age-62, 35-percent monthly annuities by 5, 10, 15, or 20 percent of their retired pay. This paper will not discuss Supplemental SBP, but by mentioning this option it allows the reader to be informed of its availability.

Further, the Reserve component also has a survivor program appropriately named "Reserve Component Survivor Benefit Plan (RC-SBP)". Participation plans and categories are somewhat identical to SBP, though with small modifications. RC-SBP will also not be addressed in this paper.

As mentioned earlier, when a member elects SBP, the participant is really electing coverage in a category for a beneficiary. Each of the five categories carry different costs to the retiree in the form of SBP premiums. Accordingly, a discussion of these costs to the participant and the formulas used for computing premiums is important to understanding the program and how it affects a member's retired pay.

### **4. Cost**

Modeled after the Civil Service Survivor Benefit Plan, SBP was not intended to be a self-supporting program, but rather was designed to operate on a cost-sharing basis between



the Government and the retired member. With the envisioned achievement of an 85 percent plan participation level it was projected that the cost-sharing ratio would be apportioned approximately 60 percent to the retiree and 40 percent to the Government. The resulting participation cost for SBP to the retired member was expected to be less expensive than was the case under RSFPP. A projected representative SBP member monthly participation cost of about 10 cents per dollar of monthly annuity coverage represented a substantial decrease from RSFPP. In addition to the cost-sharing aspect, the member participation cost formula for SBP is essentially the same for all members electing the same category of coverage and does not, in the case of spouse coverage, consider the member's age, spouse's age, or the member's disability/non-disability status. [Ref. 1: p. IV-3]

Generally, SBP premiums (member costs) are paid in the form of a payroll reduction in retired pay or VA compensation, and/or by direct remittance from the member. The amount reduced and/or remitted depends on the base amount chosen by the member and the elected category. As such, an examination of these member costs by category will be presented.

*a. Spouse/Former Spouse Coverage*

Coverage for spouse and former spouses are the same. Public Law 101-189 enacted November 29, 1989 and effective March 1, 1990, reduced the cost of SBP coverage for the majority of participants. Premiums for members who ENTERED SERVICE ON OR AFTER March 1, 1990, are computed at 6.5% of the member's base amount. Premiums for members who ENTERED SERVICE BEFORE March 1, 1990, are computed at either 6.5%

of the member's base amount or 2.5% of the first \$411<sup>5</sup> of the base amount, plus 10% of the remaining base amount, whichever method results in a lower premium. [Ref. 4: p. 126]

***b. Child(ren) Only Coverage***

Premiums for child coverage is calculated using an actuarial factor determined by a combination of the ages of the member and the member's youngest child at time of enrollment. Generally, premiums are about 2.5% of the annuity on average, but could be higher or lower depending on the difference in the age span between the member and the youngest child. [Ref. 4: p. 126]

***c. Spouse/Former Spouse and Child(ren) Coverage***

Spouse or former spouse premiums are calculated in exactly the same manner as premiums for spouse-only and former spouse-only coverage, plus a very small additional charge for the children (usually under \$1). This additional charge is computed actuarial depending on the member's age, spouse/former spouse's age, and the youngest child's age on the date of the member's retirement. Generally, the older the ages of the beneficiaries, the less the monthly premiums. [Ref. 3: p. 72]

***d. Insurable Interest Coverage***

Premiums for insurable interest coverage are 10% of the member's gross retired pay, plus an additional 5% for each full five years the beneficiary is younger than the member. The premium may not exceed 40% of the member's retired pay. Premium

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<sup>5</sup>This amount increases at the same time and by the same rate as cost-of-living adjustments to active duty military pay. \$411 is the rate effective as of January 1, 1995.

reductions in retired pay continue as long as the beneficiary remains alive or until the member changes the election to cover a spouse and/or child(ren) acquired later or requests termination of the insurable interest coverage. [Ref. 4: p. 127]

As can be seen, SBP is a complicated program. It's made even more complicated because of all the changes it has undergone in its 20 plus year history, each of which has been an improvement to member participants. Survivor Benefit Plan is one service benefit that keeps getting better. This program is essential to effective and efficient personnel management in order to provide a balanced and well-rounded military compensation package and retirement system. As a sub-element of the retirement system, the Survivor Benefit Plan for members of the uniformed services supports the objective of offering members and dependents the financial security that is available to participants in other survivor programs [Ref. 6: p. 97]. Though termed a benefit, it is important to understand SBP costs are born both from the retiree and the Government.

#### **D. DEFINED BENEFIT vs. DEFINED CONTRIBUTION**

When the SBP program was designed in 1972, Congress decided that the Federal Government would recognize the contributions of spouses to military service member's careers by subsidizing the benefits they would receive under SBP. Premium rates were established at a level which would result in retirees, as a group, contributing over their lifetimes approximately 60% of the benefits their surviving spouses would receive over their lifetimes. The Government would pay the remaining 40 percent [Ref. 3: p. 32]. Combine this subsidy with the automatic increases in cost-of-living adjustments (COLAs) to SBP

annuities along with the pre-tax treatment of SBP premiums, and together SBP becomes a "defined benefit". In other words, the "present value"<sup>6</sup> of an annuity received by a surviving spouse greatly exceeds the retiree's actual contribution cost in present dollars. This defined benefit is superior to any alternative life insurance or "defined contribution" plan (i.e., investments, mutual funds and etc.) offered in the marketplace, given the SBP premium was invested monthly by the retiree, and earned a reasonable annual rate of return.

### 1. What is SBP Worth?

The value of SBP benefits is directly dependent on the amount of a member's retired pay (or base amount), and the age of the surviving spouse at the time of the member's death. Figure 2-1 illustrates the present value of a widow's SBP benefits **PER \$1,000 OF RETIRED PAY** if benefits begin being paid at the depicted ages. These figures assume COLAs of 5 percent (the approximate average for retired pay over the past 30 years) and are based upon normal life expectancies of females at the illustrated ages. For example, if a surviving spouse is 40 years old when a servicemember retires, and the base amount is \$1,000, the value of her SBP benefits, if the retiree died on the date of retirement, would be \$159,021. This is how much life insurance the retiree would need to leave his spouse to replace SBP. The decreasing values illustrated for older ages might lead one to believe that SBP is not as much of a bargain for members retiring at older ages. Just the opposite is actually the case. If an older retiree lives to normal life expectancies, they will pay premiums

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<sup>6</sup>The term present value refers to the value now of an amount to be received at some date in the future.

for fewer years than members retiring at younger ages, and the Government subsidy is generally much higher. [Ref. 3: pp. 29 & 30]

### **"PRESENT VALUES" OF SBP BENEFITS**

This chart illustrates the "present value" of a widow's SBP benefits **PER \$1,000 OF RETIRED PAY** if benefits commence on the indicated ages. The term present value refers to the amount of money (or life insurance proceeds) a surviving spouse would need at the time of a member's death to invest at a 7% (taxable) interest rate to produce an inflation-adjusted income stream equal to what the beneficiary would receive from SBP.

<b><u>Spouse Age At Retirement</u></b>	<b><u>Value Upon Retirement</u></b>	<b><u>Value At Age 62</u></b>	<b><u>Value At Age 75</u></b>
23	\$211,368	\$481,999	\$571,496
28	197,676	377,659	447,782
36	172,889	255,615	303,077
38	166,068	231,850	274,899
40	159,021	210,295	249,342
42	152,045	190,744	226,160
44	145,312	173,010	205,134
46	137,091	156,925	186,063
48	130,401	142,336	168,764
52	114,599	117,100	138,843
58	89,417	87,382	103,607

Source: Survivor Benefit Plan Counselor's Guide, 1 January 1992.

**Figure 2-1 Present Values Of SBP Benefits**

## **2. Subsidized Benefits**

Figure 2-2 illustrates the value of the premiums a 40-year-old retiring member would pay over his lifetime and the value of the benefits his surviving spouse would receive over her lifetime. The difference represents the Government subsidy. The solid bars illustrate the cumulative value of the members SBP premiums assuming premiums increase each year along with a 5 percent rate of inflation and are invested at a 7 percent taxable interest rate. The shaded bars illustrate the "present value" of SBP benefits at each age of the member's assumed death. This illustration also assumes the member's spouse is 2 years younger than the member (the average age difference between military retirees and their spouses is 2.25 years). While a surviving spouse who begins receiving benefits at age 74 would receive far fewer years of benefits than one who begins receiving benefits at a much younger age, the present value of the SBP benefit continues to increase due to COLA increases. [Ref. 3: p. 30]

## **E. SUMMARY**

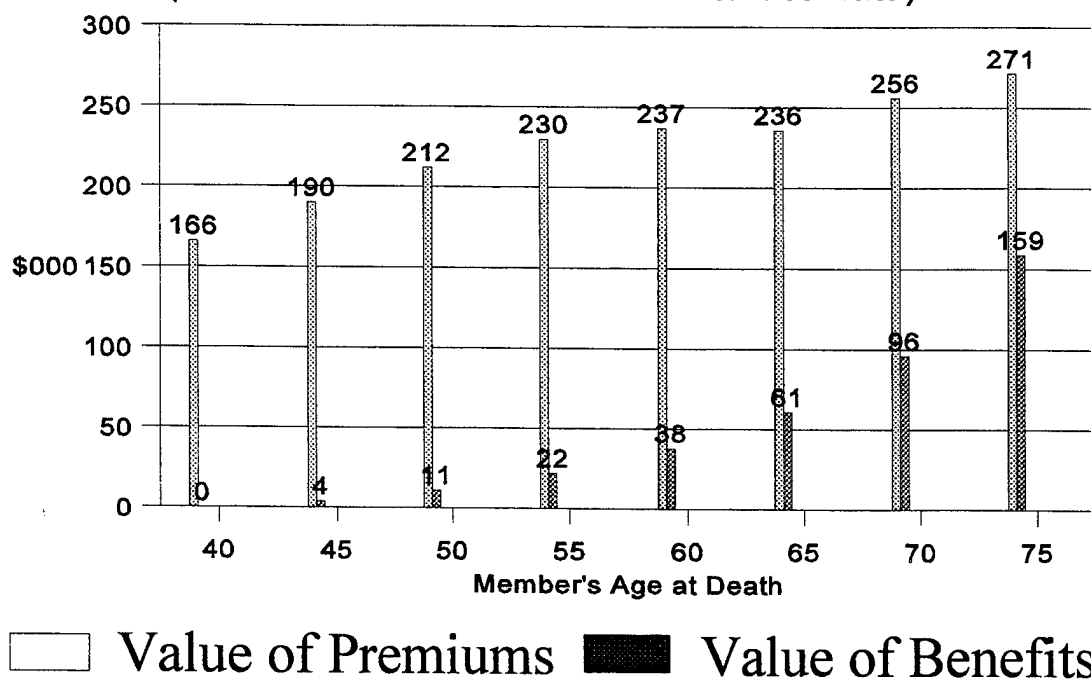
The Survivor Benefit Plan has grown tremendously in legislation and benefits since its inception during the early 1950s. The various beneficiary categories and associated costs make SBP a complex program and difficult for most retirees to make a properly informed decision regarding participation. Those who take the time to figure out the advantages of the automatic increases in COLA adjustments, the pre-tax treatment of premiums and the present value of future income streams soon realize what a valuable benefit SBP offers. Discussed too, was the fact that SBP is a sub-set of the military retirement system. In particular, SBP

is funded through the Military Retirement Fund (MRF) which was established in FY 1985 by Congress. In order to fully understand SBP and its relationship with the MRF, a review of the legislative and funding evolution of the MRF needs to be explored.



# SUBSIDIZED BENEFITS

(Assumes 5% Inflation & 7% Interest Rate)



Source: Survivor Benefit Plan Counselor's Guide

**Figure 2-2** Government Subsidy of SBP Benefits



### **III. THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND:**

#### **RELATIONSHIP TO SURVIVOR BENEFIT PLAN**

##### **A. INTRODUCTION**

The origination of the Department of Defense Military Retirement Fund was the result of perseverance by Congressional members in FY 1984 to raise cost awareness and update accounting procedures for all programs in the Military Retirement System. Prior to 1 October 1984, the military retirement system operated on an unfunded or "pay-as-you-go" basis [Ref. 7: p. B-6]. That is, as retirement and survivor annuity liabilities arose, they were funded by congressional appropriations from current year dollars. This chapter will discuss the forerunners to the actual legislation and explain the transaction process of the Military Retirement Fund brought about by the reform in FY 1985. Further, this chapter will describe the responsibilities of the Department of Defense, Office of the Actuary in managing the assets and valuation of the Military Retirement Fund. Lastly, this chapter will present the role of the Defense Finance and Accounting Service (DFAS) in administering the Survivor Benefit Plan with relation to the Military Retirement Fund.

##### **B. LEGISLATIVE FORERUNNERS**

In April 1978, the Carter Administration proposed for FY 1979 the establishment of a retirement fund, accrual accounting and changes in retirement benefits for the military. The proposals for the retirement fund and accrual accounting were largely accepted by the House Armed Services Committee, and thus, H.R. 12392 was introduced. This bill, as well as a

1979 follow on, H.R. 3261, never made final passage in Congress. [Ref. 8: p. 1] & [Ref. 9: p. 63]

On April 16, 1980, House Representative Les Aspin submitted his version of a military retirement proposal titled "Uniformed Services Non-Disability Retired Pay Reform Act." This proposal contained legislation for a retirement fund, accrual accounting and a major overhaul of retirement benefits. This bill also never made final passage. Ironically thereafter, Les Aspin was perceived as an adversary by military retirees, and this tampering of military retirement benefits also raised an atmosphere of mistrust for Congress by service personnel. [Ref. 10: pp. 8115-8117]

By 1983, two more proposals were in the makings. The Reagan administration adopted the Carter Administration's proposals less the benefits modifications, and the second proposal was another House Armed Services Committee recommendation sponsored again by Les Aspin. The two proposals differed only in the technical aspects of the retirement fund. Additionally, these proposals addressed only the retirement fund and accrual accounting while deferring the battle over retirement benefits for another day. [Ref. 11: p. 3] & [Ref. 12: pp. 9-10]

The bill proposed by the House Armed Services Committee prevailed. On September 24, 1983, Congress passed Public Law 98-94 commonly referred to as the "Department of Defense Authorization Act, 1984". Consequently, Title 10--United States Code containing the general and permanent laws of the Armed Services was amended by adding chapter 74 under section 95, and established the Department of Defense Military Retirement Fund

under section 95, and established the Department of Defense Military Retirement Fund beginning October 1, 1984. [Ref. 13: § 1461-1467]

### **C. THE DEPARTMENT OF DEFENSE MILITARY RETIREMENT FUND**

The FY 1984 DoD Authorization Act was one of the most significant pieces of legislation to make changes to the military retirement system. Two major changes from this act were the establishment of a Military Retirement Fund, and implementing accrual accounting. The principal motivation guiding the evolution of the Military Retirement Fund is best summed up by the federal code:

There is established on the books of the Treasury a fund to be known as the Department of Defense Military Retirement Fund (hereinafter in this chapter referred to as the 'Fund'), which shall be administered by the Secretary of the Treasury. The Fund shall be used for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under military retirement and survivor benefit programs.

10 U.S.C. § 1461

The biggest change to the military retirement system was the requirement to implement accrual accounting. What is accrual accounting? Simply stated, it's an accounting principle that says costs and revenues should be recognized in the period in which they are actually incurred, even though the funds involved may be paid out or received during another time period. For the military retirement system, that meant including in each year's budget an amount sufficient to pay the future retirement benefits earned by active duty military members during the same year. This amount was then to be deposited into the Military Retirement Fund.

## **1. The 'Fund'**

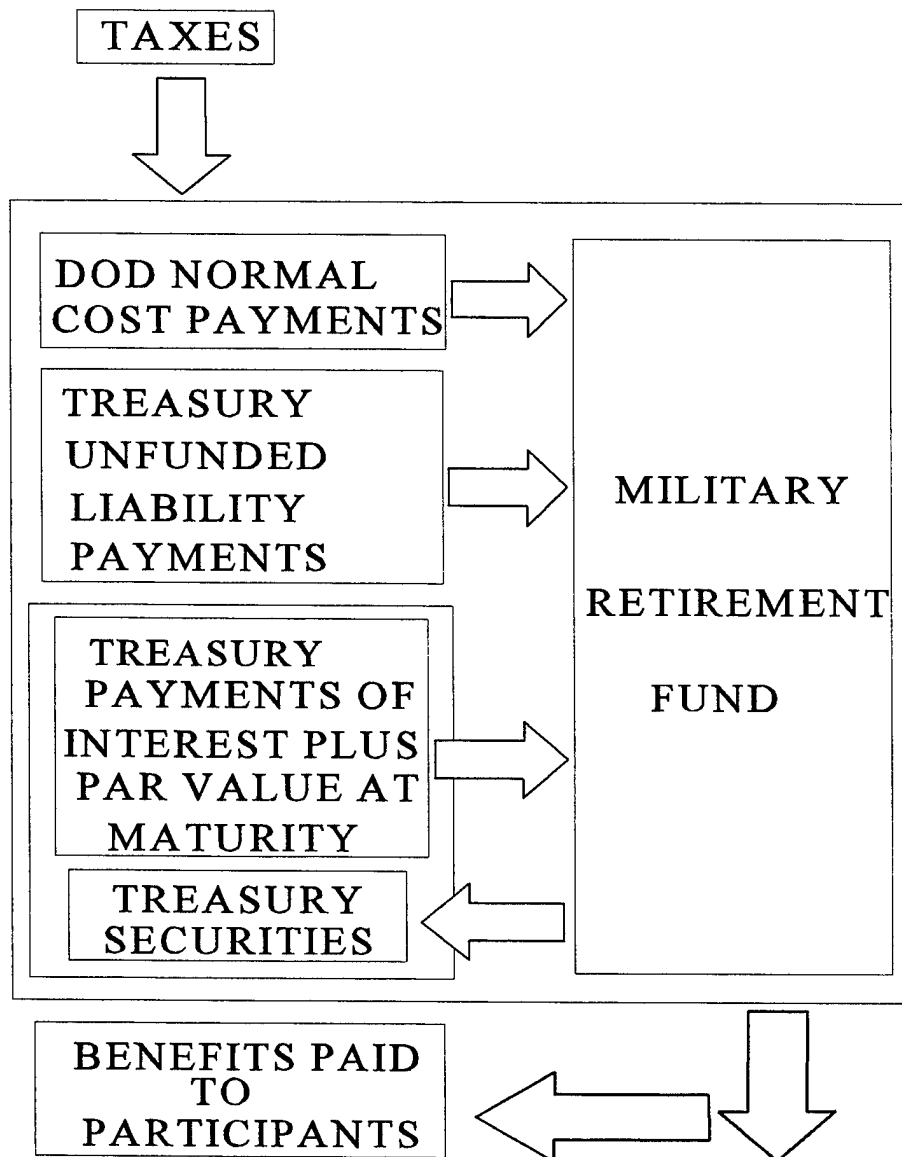
As stated earlier, only people in plans administered by the Department of Defense benefit from this Fund. It is a funded, non-contributory defined-benefit plan that includes nondisability retired pay, disability pay, retired pay for reserve service, and survivor annuity programs. Since the Fund and new accounting system became effective on October 1, 1984, the previous unfunded future liability from members who had entered the service before this date became evident. The Department of Defense Authorization Act of 1984, states that DoD will make normal cost payments into the fund, and the Treasury Department will make payments from general revenues to amortize the unfunded liability attributable to service in the armed forces performed before October 1, 1984. [Ref. 7: p. B-6]

As shown in Figure 3.1, a third source of funding that contributes to the assets of the Fund is interest earned by the Fund's resources. All three of these asset sources are intragovernmental transfers consisting of debits from one government account and credits to another. Additionally, the Fund has two payouts: (1) payments to retirees and survivors of retirees and (2) purchases of U.S. Treasury securities. The purchase of a Treasury security is also an intragovernmental transfer, while a payment to a retiree or a survivor is not.

## **2. Department of Defense Cost Payments**

The Secretary of Defense determines each year the total amount of DoD contributions designed to fund the future retirement liability created by military personnel currently on active and reserve duty. By law, monthly payments into the Fund is required from moneys appropriated by Congress for the pay and allowances of members of the armed forces on

## Military Retirement Fund Transaction Process



Source: From Valuation of the Military Retirement System, DoD, Office of the Actuary, 1993.

**Figure 3-1** The Military Retirement Fund Transaction Process

active duty and in the reserves [Ref. 13: pp. 646-647]. This contribution to the Fund is referred to as the "retirement accrual charge" or "normal cost" of the Military Retirement System. The contribution is computed using population and pay projections generated by actuarial techniques. A pre-determined *normal cost percentage* (NCP) of the total basic pay paid a particular month to members of the armed forces is determined using methods and assumptions that are approved by a DoD Board of Actuary and are in accordance with generally accepted actuarial principles and practices. [Ref. 7: p. 8]

As shown in Table 3.1, in FY 1994, the NCP was 36.0 percent of basic pay for full-time and 10.6 percent for part-time reservists. Public Law 99-661, enacted in November 1986, mandated that two separate normal cost percentages be used for the valuation of the military retirement system. One NCP is for active-duty personnel and full-time reservists (full-time) and the one is for part-time reservists (part-time) [Ref. 7: pp. 8-11]. For FY 1995, the NCP was 33.3 percent for full-time personnel and 9.7% for part-time reservists [Ref. 14: p. 11]. Over time, economic assumptions and modifications in benefits for future retirees will result in a conservative increase or decrease to these normal cost percentages.

In order to pay for this retirement accrual charge for current active and reserve forces, Congress automatically increases the annual appropriation to the Military Personnel Account within the DoD budget by the NCP amount necessary to fund the future liabilities of retired pay. There are three distinct retirement benefit formulas (relevant to three distinct populations) that apply within the military retirement system. For personnel entering the Armed Services before September 8, 1980, retirement pay is based on the final basic pay



(FINAL PAY) at the time of retirement, and/or based on the average of the highest 36 months (HI-3) for those entering on or after this date. Additionally, members first entering the Armed Services on or after August 1, 1986 are subject to a reduction (REDUX) if they retire with less than 30 years of service. A single normal cost percentage for the entire population is

**Table 3.1 NORMAL COST AS A PERCENT OF BASIC PAY, FY 1994**

<u>FULL-TIME</u>	<u>FINAL PAY</u>	<u>HI-3</u>	<u>REDUX</u>	<u>WEIGHTED</u>
Nondisability Benefits	40.0%	35.2%	29.8%	34.1%
Disability Benefits	1.3	1.1	1.0	1.1
Survivor Benefits	1.0	0.8	0.7	0.8
Total	42.2%	37.1%	31.5%	<b>36.4%</b>

<u>PART-TIME</u>				
Nondisability Benefits	11.1%	10.3%	9.3%	10.2%
Disability Benefits	0.0	0.0	0.0	0.0
Survivor Benefits	0.6	0.5	0.4	0.5
Total	11.7%	10.8%	9.8%	<b>10.6%</b>

Note that columns may not add exactly due to rounding.

Source: Valuation of the Military Retirement System, DoD, Office of the Actuary, 1993.

obtained by weighting the NCP (WEIGHTED) for each retirement group by its expected percentage of payroll in the relevant year. [Ref. 7: pp. 8 & F-2].

As can be determined from Table 3.1, about 95 percent of the full-time normal cost stems from nondisability retirement. Based on current decrement rates, 17 percent of a typical group of new entrants attain 20 years of active duty service and become eligible for nondisability retirement from active duty. Specifically, 48 percent of new officers and 15 percent of new enlistees attain 20 years of active duty service [Ref. 7: p. 12]. By adopting accrual based accounting, Congress allowed future retirement outlays to be recognized as a future liability and thus required the DoD to pay for these retirement benefits as they were earned.

### **3. Funds Received from the U.S. Treasury**

The unfunded liability portion of the Military Retirement Fund is financed from the U.S. Treasury. These assets, which are General Government funds, are transferred by the Secretary of the Treasury to the Fund at the beginning of each fiscal year. The original unfunded liability was determined to be \$528.7 billion on September 30, 1984, and is currently being amortized over 60 years and will continue until the year 2043. The unfunded liability is the money needed to pay for the retirement cost of members of the Armed Services for their service prior to October 1, 1984. [Ref. 15: p. 604]

Section 1465 of Title 10 requires the Secretary of Defense to determine amortization methods and schedules for the annual amortization of any changes in the unfunded liability of the military retirement system. The resulting payments are to be made by the Treasury to

the Military Retirement Fund. There are three causes of change in the military system's unfunded liability: (1) changes in benefits, (2) annual experience gains and losses resulting from actual experience deviating from expected experience, and (3) changes in actuarial assumptions used in the projected liability calculations. When a change in the unfunded liability does not fit perfectly into one of the three categories, the Board of Actuaries will determine the most appropriate one. [Ref. 7: p. Q-2]

#### **4. Investment of Assets and Interest Earned on the Fund's Resources**

The Military Retirement Fund is a trust fund (symbol 97X8097) that invests in special issue Treasury obligations bearing interest at rates determined by the Secretary of the Treasury taking into consideration current market yields for outstanding marketable U.S. obligations of comparable maturities. The investment in public debt securities is mandated by the federal code:

The Secretary of the Treasury shall invest such portion of the Fund as is not in the judgement of the Secretary of Defense required to meet current withdrawals. Such investments shall be in public debt securities with maturities suitable to the needs of the Fund,...The income on such payments shall be credited to and form a part of the Fund.

10 U.S.C. § 1467

Currently, each security issued to the Fund "mirrors" a security that has been issued to the public (i.e., it has the same maturity date and coupon rate), and may have been issued recently, or at any time in the past. The securities held by the Fund can be redeemed by the investment manager at any time before maturity for their fair market value to meet present cash flow needs [Ref. 7: p. 5].

The accrual accounting provisions, as established by the FY 1984 DoD Authorization Act, discontinued the Retired Pay, Defense appropriation. The Military Retirement Fund is established in the income security section of the Federal budget, not in the defense section. This is consistent with the treatment of payments to Civil Service and Social Security retirees. Accordingly, the military services no longer budget for the amount of retiree and survivor payments to be made during the year, instead, they budget for normal cost payments. Significant benefits achieved from this change are--increased visibility for the true effects of retirement program changes, better measure of total defense costs, and improved financial health of military retirement resources [Ref. 16: pp. 33-35]. An additional requirement from this act was to establish a DoD Retirement Board of Actuaries.

#### **D. THE DEPARTMENT OF DEFENSE - OFFICE OF THE ACTUARY**

The Department of Defense, Office of the Actuary is the primary DoD office responsible for determining the appropriate level of assets to be budgeted for the Military Retirement Fund in the President's budget and through the Treasury's annual payment. In other words, this office is responsible for keeping records necessary for determining the actuarial status of the Fund. This office produces two annual DoD reports: (1) the *DoD Statistical Report On The Military Retirement System*, and (2) the *Valuation Of The Military Retirement System*. To provide oversight of the Fund, Congress provided for an independent three member Board appointed by the President. [10 U.S.C. § 1464]

##### **1. The DoD Retirement Board of Actuaries**

As an independent DoD Board, it approves all actuarial assumptions, methods, and

amortization schedules used in determining the DoD contribution to the Fund as determined by the Office of the Actuary. The Board has several other functions which are listed below.

- a. Report to the Secretary of Defense annually on the actuarial status of the Fund.
- b. Report at least every four years to the President and Congress on the status of the Fund.
- c. Approve all actuarial methods, assumptions and amortization schedules used in determining the amount given to the Secretary of the Treasury to meet the unfunded liability amortization.

In fulfilling their duties as independent actuaries, the Board members work closely with the Office of the Actuary. This office provides all technical and administrative support to the Board. [Ref. 7: p. 1]

## **2. Valuation Data and Procedures**

Valuation input data is abstracted by the Office of the Actuary from files maintained at the Defense Manpower Data Center (located at Ft. ORD, CA.). Data on individual retirees and survivors comes from official files submitted by the Defense Finance and Accounting Service. These totals from September 30, 1993, are summarized in Table 3.2. Both data files are aggregated and edited, and a very small adjustment (less than .01%) is made so that the number and net retired pay amounts agree with official totals supplied by DFAS. Active duty data comes from files provided quarterly by the four military personnel centers, and this data is edited and adjusted by less than 0.1 percent to agree with official totals supplied by the DoD Comptroller [Ref. 7: p. 2].

Population and pay projections are generated mathematically by the Office of the Actuary using an actuarial projection computer model called "GORGO". This model

computes the aggregate entry-age normal cost percentage for a particular active duty population by grouping them into "cells" by age and number of years of service. These cells

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**Table 3.2 ACCOUNTING FIGURES AS OF SEPTEMBER 30, 1993**

Total Active Duty Personnel + Full-Time Active Duty Reservists	1,763,097
Total Monthly Basic Pay	\$2.96 billion
Total Selected Drilling Reservists	987,165
Total Monthly Basic Pay	\$.30 billion
Total Number of Nondisability Retirees	1,428,722
Total Monthly Retired Pay	\$1.95 billion
Total Number of Disability Retirees	127,155
Total Monthly Retired Pay	\$.12 billion
Total Number of Surviving Families	191,642
Total Monthly Survivor Annuities	\$.10 billion

Source: Valuation Of The Military Retirement System, DoD, Office Of The Actuary, 1993.

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contain the number and the average basic pay for that particular group. Data on the retired population and surviving families are also grouped into cells by age, and each cell contains the number and average net retired pay or survivor annuity. GORGO is also programmed to compute the unfunded liability, in addition to being affected by economic assumptions (i.e., inflation rate, annual basic pay raise, and annual valuation interest rate). Lastly, GORGO has

a number of parameters which affect its results. Examples include the rates of election of the Survivor Benefit Plan and member-spouse age differences to name a few. In other words, SBP premium amounts that flow into the Military Retirement Fund, as a percent of gross retired pay, and by age and officer/enlisted status are taken into account within this model. Basic pay and benefits are projected over the next 100 years, and then discounted back to the present to find the normal cost percentage. Mathematically, the "GORGO" model determines a normal cost percentage by dividing the present value of future benefit payments for the entire cohort by the present value of future basic pay. Future basic pay outlays are then used for budget projections by DoD. [Ref. 7: p. 4]

#### **E. THE DEFENSE FINANCE AND ACCOUNTING SERVICE**

The establishment of the Defense Finance and Accounting Service (DFAS) in January 1991, was a giant first step to improve DoD finance and accounting operations. DoD Directive 5118.5 of November 26, 1990, officially established DFAS as an agency of the Department of Defense under the direction, authority, and control of the DoD Comptroller. As the "accounting firm of DoD", DFAS capitalized<sup>7</sup> those installation-level activities performing accounting and reporting for all General funds, Defense Business Operations Fund Revolving funds, Trust funds and other accounts [Ref. 17: pp. ES-3, 3]. In particular, DFAS became, and is, the single DoD agency responsible for managing retiree pay, the Survivor

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<sup>7</sup>Capitalized refers to the transfer of ownership and/or command and control of people, resources and assets involved in performing DoD finance and accounting functions from the DoD components where they reside to DFAS.

Benefit Plan, and the Military Retirement Fund. Since the Fund (Symbol 97X8097) is an Office of the Secretary of Defense account, the DFAS headquarters at Washington D.C., is responsible for its overall accounting, and reporting.

Prior to the evolution of DFAS, there were eight military retiree and annuitant pay systems within the DoD that paid more than 1.8 million retirees and annuitants. With the implementation of DFAS, approval was granted to adopt the Navy retiree system and the Air Force annuitant system as the DoD migratory systems. This included centralizing the retiree pay section at DFAS--Cleveland Center and the annuitant pay section at DFAS--Denver Center. The two subsystems were integrated into a migratory standard system, referred to as the Defense Retiree and Annuitant Pay System (DRAS), and data is passed electronically between the two centers and the Military Retirement Fund at Washington, D.C. [Ref. 18: p. 34]. The migratory DRAS system has recently been modified in 1995, and now contains an additional subset program referred to as the Retired and Casualty Pay System (RCPS). Centralization and consolidation of retiree and annuitant pay accounts at the two centers and its headquarters office allows for standardized data exchange, improved and detailed account statements, and responsive customer service.

#### **F. SUMMARY**

The Military Retirement Fund began in FY 1985 and serves to pay for the costs of military retirement. Through accounting reform, this cost is arranged into two categories. The normal cost of future retirements is given to DoD and cost of the original unfunded liability is given to the U.S. Treasury. The Department of Defense Office of the Actuary



supplies the DoD with the necessary dollar figures to budget for military retirement and the payment on the unfunded liability. These dollar figures are computed through use of a sophisticated computer model which incorporates the effects of numerous retirement benefits, decrement rates, DoD specific parameters and a broad range of economic parameters. DFAS is the sole agency responsible for all finance and accounting efforts throughout the Department of Defense. Consolidation of all military retiree and survivor annuitant pay services from the various service components through DFAS has improved financial accounting and reporting through standardization. With consolidation and improvement, recent concerns from the DFAS Annuity Pay section--Denver, have evolved over the accounting of specific Survivor Benefit Plan premiums and their potential impact on the fiscal integrity of the Military Retirement Fund. The next chapter examines these specific transactions.



#### **IV. THE DIVERSION OF SBP PREMIUMS: ANALYSIS OF DIRECT REMITTANCES DEPOSITED INTO THE U. S. TREASURY**

##### **A. INTRODUCTION**

Previous chapters discussed the Survivor Benefit Plan and its parent trust fund, the Military Retirement Fund. Retirees and survivor annuitants are paid from the Military Retirement Fund. SBP premiums (member costs) are most often paid by retirees via the payroll reduction method from their retired pay. In other words, SBP premiums are calculated and automatically deducted from a retiree's monthly entitlement and remain in the Military Retirement Fund. This is logical because this is the same account from which a survivor will be paid an annuity upon a servicemembers death. SBP premiums paid from a servicemember's VA compensation, or from the retired service member directly are classified as 'direct remittances', and, by law, are collected and deposited by DFAS into a U. S. Treasury Receipt account (general fund) vice the Military Retirement Fund. This chapter defines and examines the statutory requirements for accounting of direct remittances submitted as Survivor Benefit Plan premiums. A cursory look into the Retired and Casualty Pay System (RCPS), and the accounting flow process of direct remittances as implemented by DFAS will be presented. Lastly, the data gathering strategy and an analysis of direct remitted data for FY 1995 will be examined, and a discussion on the consequences these diversions have on the Military Retirement Fund will be provided.

## **B. RETIRED PAY**

The specific base pay to use in computing an individual's retired pay depends upon many particulars relating to the individual and recent retired and active duty pay increases. The Defense Finance and Accounting Service (DFAS)-Cleveland, the agency responsible for the accounting of retired pay, makes all calculations and automatically provides retirees with the benefit of the most advantageous retirement formula on an individual basis. The standardized Retired and Casualty Pay System is the new accounting system used by DFAS-Cleveland to consolidate accounting of all retired, and casualty pay within DoD. It is a subset program of the bigger on-line computer system, the Defense Retiree and Annuitant Pay System (DRAS). DRAS is linked to all the services' personnel centers, so when a service member retires all retired pay entitlement information is automatically transferred via electronic telecommunications to DFAS-Cleveland (retired pay). All four of the military personnel systems pass along detailed information about the new retiree, including years of service, rank, and marital status. The DRAS system also contains extensive information on the retiree's election and the annuitant's enrollment in the Survivor Benefit Plan . [Ref. 19: pp. 7-9]

### **1. The Retired and Casualty Pay System**

When a servicemember retires and elects the Survivor Benefit Plan , an electronic data interchange occurs between the retiring member's service personnel office and DFAS-Cleveland. Information regarding the SBP coverage elected, calculation of retired pay, premium cost, and other retirement pay information is entered into RCPS, via the DRAS on-

line computer system, and relayed to DFAS--Cleveland. RCPS builds a data collection record on each retiree. Each month this program automatically calculates and pays the retirement entitlement to each member minus taxes, allotments, Veteran's Administration (VA) compensation, SBP premium costs, and other government or legal debts accrued by the member [Ref. 20:]

## **2. Direct Remittance Processing**

Some military retirees, however, do not receive retired pay from the Military Retirement Fund because they are entitled to full VA compensation, or have continued employment in the Civil Service sector which, by law, mandates an offset to their retired pay. Other military retirees may receive only a partial entitlement, and do not receive enough retired pay to fully pay for their SBP costs. These types of individuals will be computer coded within RCPS as direct remittants.

### ***a. VA Direct Remittants***

When a member's retired pay is suspended due to receipt of VA compensation, the member is required to make payments to DFAS-Cleveland for any premiums due for the Survivor Benefit Plan. Member's with a VA waiver may choose to have payments taken out of their VA compensation and sent directly to DFAS-Cleveland from the VA, instead of making direct remittances of premiums (i.e., instead of a retiree mailing a check or money order directly for the premium cost). The VA sends a monthly tape of all authorized SBP payments to the Cleveland center, along with a single payment which is applied to the accounts of all members shown on the tape. Members who pay by VA deduction are

furnished with a statement each month to let them know that the VA has sent a payment. If an account paid by VA deduction becomes delinquent, the member is liable for the amount owed and is then issued a bill. Delinquent accounts from members paying SBP premium costs directly by mail may be referred to the VA for collection purposes. [Ref. 21: pp. 1-2]

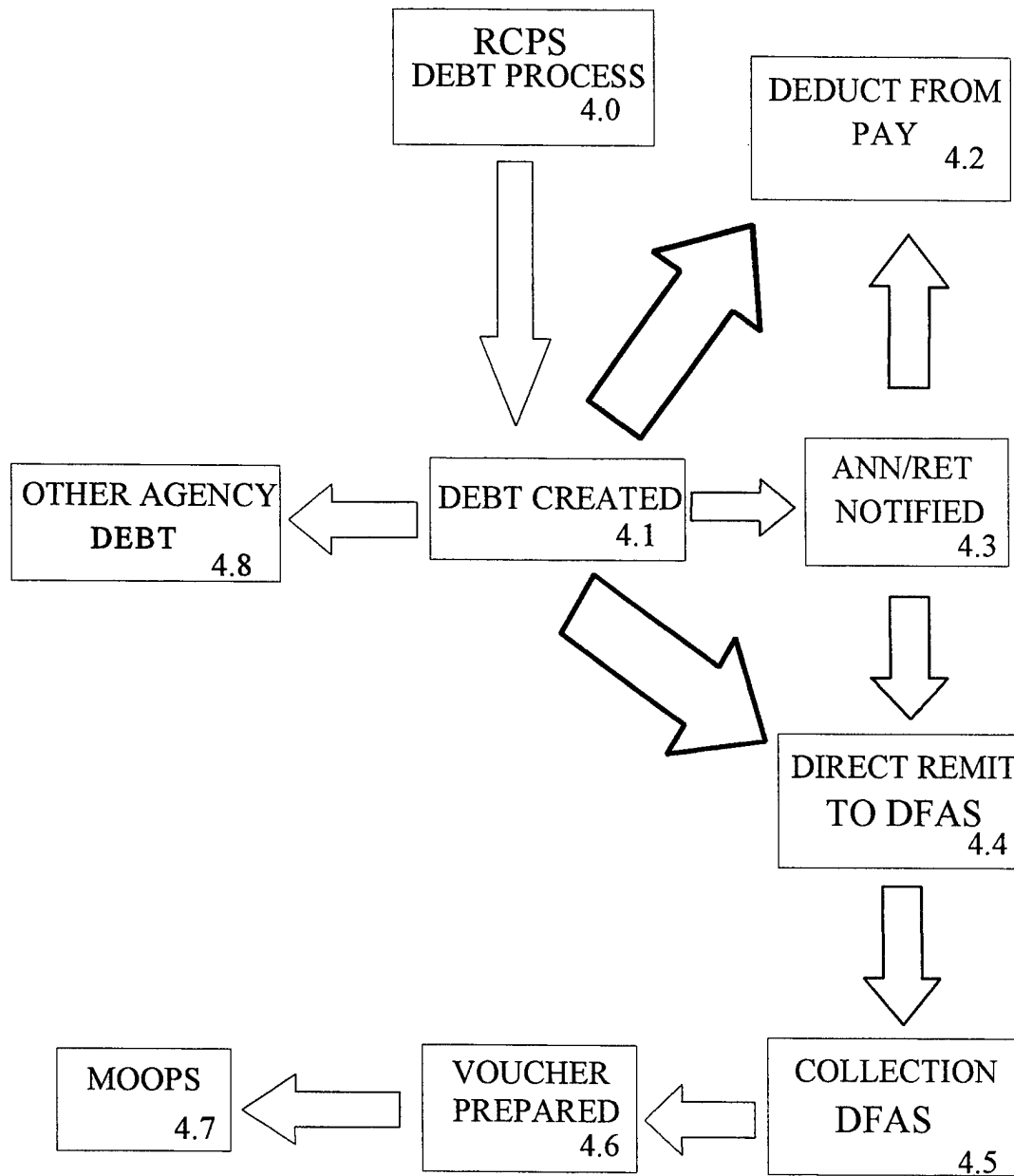
***b. Civil Service and Other Direct Remittants***

Former military members also entitled to a Civil Service retirement pension may elect coverage under the Office of Personnel Management (OPM) Survivor Benefit Plan and terminate coverage under the DFAS-Cleveland Survivor Benefit plan, eliminating the need for direct remittances of premiums. These members, however, may remain in the latter plan and pay SBP premiums directly to the Cleveland center. For these and other retirees coded as direct remitter, RCPS generates a bill each month for members who owe costs and are paying by direct remittance. It is the member's responsibility to pay by the 28th day of each month for the following months premium cost. Payments are either sent to DFAS-Cleveland, or to the financial institution (First National Bank of Chicago) responsible for collections. Delinquent amounts are charged a 6% yearly interest (.00487 per month). If a member becomes delinquent in his/her payments, or refuses to pay, an account cost balance is maintained in RCPS. When the member dies, all accrued premiums plus interest will first be deducted prior to any annuity amounts paid to eligible survivors. [Ref. 21: p. 2]

Figure 4-1 provides a general overview of the accounting flow of SBP costs within RCPS. Starting in block 4.0 RCPS--Debt Process, this represents the monthly account maintenance and payroll processing within the retired and annuitant pay systems. A debt

# RETIREE AND ANNUITANT SYSTEM

## ACCOUNTING FLOW



From: Denver Retiree and Annuitant System Accounting flow, 1995

**Figure 4-1** Retiree and Annuitant System Accounting Flow

(SBP premium) may be created via the system or online processing (block 4.1). After creation of a debt the retiree may be notified in accordance with due process rules and regulations. Some debts are deducted from a retiree's pay (block 4.2). The deduction is computed or recognized in the End of the Month (EOM) processing of the retiree and annuitant pay processing systems. When required, the retiree is notified of a debt (i.e., debts owed to the trust fund, or if the retiree is not in a paying status), as seen in block 4.3. A direct remittance from the retiree is the other form of payment for a debt (block 4.4). This type of a payment is received by DFAS, or DFAS is notified of a collection from their financial institution through monthly statements. Payment data is collected by DFAS and is processed in RCPS (block 4.5). A DD Form 1131, voucher, is prepared for direct remittances (block 4.6). Finally, input to the Microcomputer Online-Offline Processing System (MOOPS) is conducted, as required, to transmit data for input to the allotment ledger, open document listing and trend analysis documents within DFAS. Other agency debts (block 4.8) are debts which the retiree may owe to another agency. [Ref. 22: p. 8]

### **C. REDUCTION IN RETIRED PAY**

Members of the Armed Forces and the military retirement system are covered under the federal statutory laws of United States Code, Title 10. Sections 1447 through 1455 of Subchapter II refer to the entitlements and regulations of the Survivor Benefit Plan. Paragraph (d) of Section 1452, in particular, refers to the law concerning direct remittances:

If a person who has elected to participate in the Plan has been awarded retired pay and is not entitled to that pay for any period, he must deposit in the Treasury the amount that would otherwise have been deducted from his pay



pay for that period for that period, except when he is called or ordered to active duty for a period of more than 30 days."

10 U.S.C. § 1452

In general, for any period that a member is not receiving retired pay because of: (1) non-entitlement to; or (2) a waiver of such pay; or (3) the pay received is not enough to cover the total cost of SBP coverage, the member must remit the amount due to the service finance activity [Ref. 5: pp. 9-28]. Accordingly, the amount remitted is collected and subsequently deposited into the general fund of the U. S. Treasury by DFAS.

#### **1. Interpretation and Policy**

The interpretation and policies of this federal statute are established by the Office of the Secretary of Defense (OSD), and have been in existence for numerous years. Policy and general procedures concerning waivers, non-entitlement, and reductions in retired pay are covered in the following regulations:

- a. DoD Instruction 1340.12, Guidance for Military Retired Pay, Deductions and Survivor Annuity Entitlement
- b. DoD Manual 1340.12-M, Military Retired Pay Manual
- c. DoD 1332.27, Survivor Benefit Plan
- d. DoD 7000.14R, DoD Financial Management Regulation.

The author could not find in any of these DoD regulations where it directly specifies DFAS to collect and deposit into the U. S. Treasury those funds classified as direct remittances. Internal policies and procedures designed by DFAS to accommodate the mandates in Title 10, and the requirements of DoD regulations must explain for this lack of written guidelines

within the DoD directives. In other words, DFAS has interpreted the federal statute and implemented internal procedures to account for, collect and deposit into the U.S. Treasury direct remittances.

## **2. Accounting for Direct Remittances**

The actual double-entry book accounting by DFAS of these type funds is too technical in scope to be addressed in detail within this paper. Because there are four sources of funds for direct remittances, there are as many accounting mechanisms for each. It would be more beneficial to present the various sources in order to allow the reader to appreciate the complexity of the accounting process. First, there are funds received by DFAS-Cleveland directly from individuals via the mail. Second, there is the monthly tape provided by the VA to the Cleveland center of all authorized SBP payments, along with the single payment which is applied to the accounts of all members shown on the tape. Third, there is the monthly deposit statement from First National Bank of Chicago of all billing collections made during the month. These collections are from those individuals not entitled to retired pay, or entitled to only partial retired pay, and the amount is insufficient to cover their monthly SBP premium costs.

Lastly, there are annuitant plus interest accrued collections made by DFAS-Denver. This type of collection is from direct remitters delinquent in their SBP premiums, who have since died, and DFAS-Denver (Annuity section) is collecting past premium costs plus interest accrued from the entitled annuity prior to any amounts being paid to the survivor. As seen, the various sources for direct remittances necessitate different accounting procedures and

practices by DFAS. In general, though, all funds collected as direct remittances are deposited into a U. S. Treasury receipt account citing the Treasury symbol 97R2462. [Ref. 23:]

#### **D. DATA PRESENTATION**

The primary research question is to identify the annual amount of SBP premiums accounted for as direct remittances, and currently being deposited into the U. S. Treasury vice the Military Retirement Fund. A subsidiary goal is to determine if this diverted amount of money is significant enough to cause unfunded liabilities to the Military Retirement Fund.

##### **1. Data Gathering Strategy and Sources**

The data gathering strategy consisted of primarily archival data generated by the Defense Manpower Data Center (DMDC), located at Ft. Ord, California, and substantiated by the Direct Remittance, Retired Pay section at DFAS-Cleveland. Additional archival data was obtained from the Annuity Pay section at DFAS-Denver. Initially, a data set of all retired pay accounts coded as SBP/RSFPP direct remittants was developed and extracted from the Retired Pay File at DMDC using SAS, a statistical analysis programming language. This data set contained the following five data elements:

<b>1. <u>SERVICE</u></b>	<b>2. <u>OPTION CODE</u></b>	<b>3. <u>CURRENT PAY STATUS</u></b>
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A = Army

N = Navy

F = Air Force

M = Marine Corps

I = Coast Guard &

NOAA

2 = SBP only

3 = SBP and RSFPP

3 = Not Receiving Pay

Direct Remittance

#### 4. PREMIUM AMOUNT

\$ Amount/Implied Decimal

#### 5. ANNUITY AMOUNT

\$ Amount/Implied Decimal

Further manipulation of this data set using SAS was accomplished to purge unqualified records (i.e., service member initially coded as direct remit, but no longer in pay status) to produce a valid population for statistical analysis. Verification and reconciliation of data was accomplished by comparing DMDC data set information with ad-hoc statistical reports produced from the Direct Remittance section, DFAS-Cleveland.

It should be noted that the SBP/RSFPP program is an active program. New retirees are continuously joining, and already joined retirees are dropping out of the programs for reasons already discussed. As such, the total number of computer coded direct remitters within RCPS and the Retired Pay File fluctuates per month. Thus, due to these fluctuations and time lag differences, comparison data between the DMDC data set and records at DFAS-Cleveland did not produce a 100 percent match. These comparative variances will be presented, when applicable.

## **2. Population Data**

An extract by service component (i.e., Army, AirForce, Marine Corps, Navy, and National Oceanic and Atmospheric Administration (NOAA)and Coast Guard) from the DMDC data set produced a total of 24,815 records coded as direct remitter as of April, 1995. As seen from Table 4.1, retirees from the Army branch make up the majority of direct remitter (i.e., 48.91%). This stands to reason since the Army historically has had the largest

population of personnel within DoD, and the highest SBP participation rate of all the component services (e.g., 59 percent participation level for FY 1993 and 1994) [Ref. 24: p. 234].

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**Table 4.1 TOTAL NUMBER OF DIRECT REMITTERS BY SERVICE COMPONENT**

<b>SERVICE</b>	<b>FREQUENCY</b>	<b>FREQUENCY PERCENT</b>
A = (ARMY)	12,138	48.91%
F = (AIR FORCE)	6,288	25.34%
M = (MARINE)	1,285	5.18%
N = (NAVY)	4,868	19.62%
P = (NOAA + CG)	236	.95%
<b>Total:</b>	<b>24,815</b>	<b>100.00%</b>

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When compared to the data provided by DFAS-Cleveland for all direct remitters on the rolls as of August, 1995, the data appears to be consistent between the two data sets. Table 4.2 reveals a total direct remitter count of 12,016 for the Army, and 22,850 total for all the services as of this date. Calculating the variance between the DMDC data set and DFAS-Cleveland records for the total number of direct remitters from all the service components reveals an error rate of less than .27 percent.

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**Table 4.2 DIRECT REMITTANCE COMPARATIVE DATA FROM DFAS-CLEVELAND<sup>8</sup>**

BRANCH	SBP-RMTD FYTD \$	RSFP-RMTD FYTD \$	TOTAL \$	COUNT
ARMY	5,728,466.68	42,383.11	5,770,839.790	12,016
NAVY	1,573,256.45	54,952.45	1,628,208.90	3,395
MARINE	555,349.13	8,153.00	563,502.93	1,105
AIR FORCE	3,002,237.47	135,469.61	3,137,707.08	6,334
Total:			11,100,258.70	22,850

Source: Data extract from Direct Remittance section, DFAS-Cleveland, August, 1995

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### **3. Dollar Value of Direct Remittances**

Further inquiry into the DMDC data set was conducted to determine the total monthly premium amount owed (i.e., accounts receivable) by SBP/RSFPP plan members coded as direct remitter. This simple extract was capable since the DMDC data set contained the calculated premium and annuity amounts, per retiree record. Table 4.3 presents this data by service component. As seen, the total monthly dollar amount was determined to be: **\$1,209,222.22**. Multiplying this monthly amount by twelve (i.e., 12 months in a year) reveals

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<sup>8</sup>Due to recent DFAS consolidation and reorganization, records obtained on direct remitter contained only 10 months worth of data for Air Force, Marine Corps and Navy, and 9.5 months for Army. Additionally, Coast Guard and NOAA members were excluded.

**Table 4.3 TOTAL NUMBER OF DIRECT REMITTERS AND MONTHLY PREMIUM AMOUNT BY SERVICE**

SERVICE	NUMBER OF DR	PREMIUM AMOUNT SUM
ARMY	12,138	\$ 580,330.43
AIR FORCE	6,288	339,746.82
MARINE CORPS	1,285	52,524.75
NAVY	4,868	224,851.68
NOAA & CG	236	11,768.57
<b>Monthly Total:</b>	24,815	\$1,209,222.22
		X 12
<b>Annual Total:</b>		<b>\$14,510,666.64</b>

that the U.S. Treasury should be benefitting somewhere in the neighborhood of **\$14,510,666.64** a year from direct remittances. Or, unfortunately, the Military Retirement Fund is losing approximately this dollar amount each and every year.

The comparison between the total dollar value of SBP/RSFPP premiums remitted fiscal year-to-date (FYTD) from Table 4.2, and the twelve month receivables amount calculated from the total in Table 4.3 substantiates even further that the data obtained and presented is reliable. The dollar amounts from these two tables are presented below in Table 4.4 for easy comparison.

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**Table 4.4 COMPARISON DATA BETWEEN 1995 FYTD REMITTED VS. 1995  
PROJECTED ACCOUNT RECEIVABLES.**

Table 4.2	SBP/RSFPP Remitted FYTD: \$ 11,100,258.70
Table 4.3	Calculated Annual A/R: \$ 14,510,666.64

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Of significance, however, is to recall that the 1995 FYTD remitted dollar amount collected by DFAS-Cleveland encompasses only 10 months of premiums from Navy, Marine Corps, and Airforce retirees; and 9.5 months from the Army, the service with the greatest number of direct remitters. Additionally, the Coast Guard and NOAA direct remittances are not included in the 1995 FYTD remitted total since these funds are not collected by DFAS-Cleveland. Accordingly, these two deviations help explain the \$3 million difference noted between the two total amounts. Yet, it can be concluded that DFAS-Cleveland appears to be in line to collect the approximate \$14 million in calculated account receivables during FY 1995 from direct remitters for SBP/RSFPP premiums. This is, of course, taking into consideration that all direct remitters pay their premiums on time. By law, these funds will subsequently be deposited into the U.S. Treasury vice the Military Retirement Fund. However, this is not the entire amount of money that is being diverted from the Military Retirement Fund as a result of direct remittances.



#### **4. Annuitant collections**

There is another source of funds considered direct remittances which are also collected and deposited with the U.S. Treasury. These funds, recall, are collected by the Annuity section, DFAS-Denver from survivor annuity accounts previously coded as direct remitter, and which contained positive cost account balances. In other words, these Plan accounts were in arrears due to unpaid SBP premiums from now deceased members. As such, a reduction in annuity entitlement to survivors occurs each month until the debt to the government is paid in full. Table 4.5 shows the actual collections made by DFAS-Denver from annuitant entitlement for FY 1995, and the projected year-end totals. As of July, 1995, the FYTD collected amount was: **\$871,091.97**. The projected year-end total is: **\$1,901,852.70**. The projected year-end total is calculated by taking an average of all collections made throughout the year by service branch, and multiplying the average by twelve. These averages are then added together to project the total annuitant collections.

**Table 4.5 ACTUAL AND PROJECTED TOTAL COLLECTIONS FROM  
ANNUITANT ENTITLEMENT**

	Air Force	Navy	Marines	Army	Total:
OCT94	\$ 11,242.00	\$21,884.57	\$ 0.00	\$ 0.00	\$ 33,126.57
NOV	30,686.37	5,623.10	2.00	0.00	36,311.47
DEC	42,713.12	25,210.55	2,711.41	0.00	70,635.08
JAN95	33,467.05	3,928.39	3,478.79	0.00	40,874.23
FEB	90,834.20	34,739.25	11,968.33	0.00	137,541.78
MAR	50,720.05	33,385.88	4,434.78	0.00	88,540.71
APR	1,367.68	21,117.65	46.13	237,698.99	260,230.45
MAY	6,716.26	11,814.05	0.00	14,698.99	32,790.08
JUN	26,678.26	12,774.09	0.00	17,638.22	57,090.57
JUL	2,855.73	58,048.68	4,880.79	48,165.83	113,951.03
AUG					0.00
SEP					0.00
Total:	\$297,280.72	\$228,526.21	\$27,522.23	\$317,762.81	<b>\$871,091.97</b>
AVG:	\$42,468.67	\$32,646.60	\$3,931.75	\$79,440.70	
	X 12	X 12	X 12	X 12	
Total:	\$509,624.09	\$391,759.22	\$47,108.97	\$953,288.43	<b>\$1,901,852.00</b>

Source: DFAS-Denver report of funds benefiting US Treasury versus DoD MRF, August 1995.

## E. ANALYSIS OF DATA

In an effort to determine the impact of these diversions from the Military Retirement Fund, the total amount of direct remittances collected by each of the DFAS centers has to be determined. This paper presented two main sources of funds classified as direct remittances. First, there are direct remitters as a result of Plan members waiving retired pay in favor of VA compensation. Secondly, there are those direct remittant collections from survivor annuity entitlement. As can be seen in Table 4.6, the FY 1995 projected annual amount of

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**Table 4.6 FY 1995 TOTAL PROJECTED DIRECT REMITTANCES  
TO BENEFIT U.S. TREASURY**

Projected Total Account Receivables From VA	\$ 14,510,666.64
Projected Total Collections From Annuitant Entitlement	\$ 1,901,852.00
Total:	<b>\$ 16,312,518.64</b>

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\$16.3 million from these two sources is a significant amount of money. These funds are being accounted for and collected by both DFAS centers at Cleveland and Denver using DRAS and RCPS on-line computer systems. Direct remittances are then subsequently transferred and/or deposited into a U.S. Treasury receipt account, thereby, reducing the assets and future value of the Military Retirement Fund. This decrease in assets and future value of the MRF occurs

because annuities for deceased members previously coded as direct remitters are paid from the MRF, though their premiums (i.e., Plan costs) were deposited into the Treasury. The entire process is systematically carried out annually due to illogical mandates specified within a federal statute of U.S.C. Title 10.

### **1. Impact on the Military Retirement Fund**

The impact of this law on the assets of the Military Retirement Fund is more than insignificant. The diversion of funds from the MRF into the Treasury is occurring every year. Consequently, millions of dollars that should be contributing to the asset value of the MRF are being used to fund other Government agencies and programs each year. Consider for example, what the financial impact is on the loss in future value to the Fund for only the FY 1995 projected direct remittant total. The future value<sup>9</sup> for this amount using twenty years as the time period and a modest interest rate of 6% is equivalent to: **\$54 million** (exactly \$53,997,772.21.) The loss in future value to the Fund of twenty periodic contributions of \$16 million each plus accumulated compound interest at 6% is significantly greater. The calculated financial loss is equivalent to: \$7,392,654,323, or approximately **\$7.4 billion**, rounded off.

### **2. Direct Remittances Increase the Normal Cost Payment of DoD**

As indicated, the diversion of direct remittances into the U.S. Treasury are a loss to

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<sup>9</sup>The future value of a single amount (i.e., the principal) is the sum to which that amount will increase at  $i$  interest rate for  $n$  periods. The future sum will be the **principal plus interest**. The future value concept is based on compound interest.

the Military Retirement Fund. This loss results from actual experience in a pension plan deviating from what was expected. Chapter 3 pointed out that the rates of election for Survivor Benefit Plan participation and corresponding premium amounts that flow into the MRF are program parameters that are taken into account in the "GORGO" model to compute the normal cost percentages (NCP). These NCP's are used to determine the monthly contributions (the DoD accrual charge) that must be transferred into the Fund by DoD. It can be defined as the level percent of basic pay contributed annually to an interest bearing fund, necessary to pay for the future retirement benefits of a group of new entrants into military service. [Ref. 14: p. 8]

As noted in Table 3.1, Survivor benefits is a component of the normal cost percentages. The Department of Defense Office of the Actuary determines the weighted NCP. A review of all the major valuation program parameters presented in the 1994 annual report and used by the Office of the Actuary to calculate NCP's was conducted. This review determined that a major parameter for direct remittances diverted to the U.S. Treasury (i.e., the loss to the Fund) did not exist [Ref. 14: pp. 14 , O-2&3]. It therefore must be concluded that these diversions are not being considered in the calculation of NCP's. As a result, the NCP percentage for the survivor benefit component, though only a fraction of the total NCP, is understated. Thus, the Office of the Actuary neglects to fully consider and account for the loss of direct remittances from the Military Retirement Fund.

Why is this loss not significantly appearing in the asset valuation of the Military Retirement Fund each year? The contribution to fund future retirement benefits from all the

Services in FY 1994 was 12.8 billion dollars [Ref. 14: p. 7]. Projected diversions of direct remittances from the Fund into the Treasury for FY 1995 was calculated to be approximately \$16 million. A numerate analysis indicates that an increase or decrease of only one-tenth of a percentage point in the NCP, when applied to a \$34.5 billion annual basic pay appropriation, equates to several millions of dollars in corresponding increases and/or decreases. Therefore, the slightest upward adjustment in one of the existing major parameters used by the Office of the Actuary results in a corresponding increase in tenths of a percentage point to the normal cost percentage. When this increased NCP is applied to a billion dollar appropriation the shortfall in millions of dollars to the Fund, because of direct remittances being diverted to the Treasury, quickly disappears. It is reasonable to expect this continued method and application in calculating normal cost percentages will unlikely result in the Military Retirement Fund experiencing any future unfunded liabilities from the diversion of direct remittances. Yet, it does mean that DoD will continue to annually fund for millions of dollars in losses that are unnecessary.

#### **F. CONCLUSION**

The Military Retirement Fund is losing millions of dollars annually as direct remittances for Plan costs are instead deposited into the U.S. Treasury. Consequently, the Fund becomes responsible to pay annuities to beneficiaries even though the deceased Plan participants never contributed to the Fund's assets. The reason, all because of an old and outdated federal statute unchanged on the books of U.S.C. Title 10.

DFAS-Cleveland is responsible for managing the nearly 2 million retiree accounts, while DFAS-Denver has more than quadrupled its annuitant accounts to about 225,000. The increased workload is all due to the recent reorganization and consolidation taking place within DFAS in order to standardize all of DoD under one retiree and annuitant pay system. The DRAS and RCPS on line computer systems utilize automatic data sharing, optical imaging and teleservices in an effort to standardize and consolidate the retiree and annuitant accounting systems throughout DoD. With standardized and consolidated policies, legislative changes --like depositing direct remittances into the MRF vice the U.S. Treasury--should be easy to implement. A change would be entered into DRAS and automatically applied to all accounts.

The millions of dollars diverted to the Treasury on an annual basis impact on the future value and fiscal integrity of the Military Retirement Fund. DoD continually pays for this loss to the Fund through higher normal cost payments than required. Retired pay benefits paid out in FY 1994 was \$26.2 billion. A reason why the Military Retirement Fund has been the object of diversions is probably because of its size. With \$124.2 billion in assets at the end of FY 1994, the Fund is an attractive source of resources [Ref. 14: p. 6]. As Congressional budget committees continue to examine proposals to cut military retirement in an effort to reduce DoD appropriations, an easy legislative change to prevent the diversion of direct remittances to the Treasury from the Military Retirement Fund could be initiated and save millions of dollars for the DoD in future years.





## **V. SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **A. SUMMARY**

In 1972, Congress enacted the military Survivor Benefit Plan, a voluntary program for military retirees. It is a program designed to provide income protection for dependent survivors of servicemembers who die in retirement or while on active duty after reaching retirement eligibility. Under this plan, military retirees receive a reduced military pension in return for the guarantee of benefits to their survivors. The retiree can elect whether to participate in the SBP and how much of his/her retirement pay to "cover" under the plan subject to a minimum coverage of \$300 a month. The election, once made, is irrevocable. Those who elect to cover some or all of their retirement pay under SBP contribute in the form of a reduction in that pay. When the retiree dies, his/her survivor receives for the remainder of their lifetime 55 percent of the retiree's covered retirement pay as an annuity, less certain social security offsets once attaining the age of 62. The annuity and the offsets are adjusted for future increases in the Consumer Price Index.

Generally, SBP premiums are paid in the form of a payroll reduction in retired pay or VA compensation, and/or by direct remittance from the member. The amount reduced or remitted depends on the base amount chosen by the member and the elected category of coverage. The SBP is a complex program with numerous provisions. These govern coverage of persons other than spouses; effects of death of servicemembers, spouse death, divorce, and remarriage; effects on the offset of reductions in social security; and a host of other

provisions. Lastly, participation in the SBP is a shared cost between the servicemember and the Government.

The Military Retirement Fund was created in FY 1985 through legislation which reformed the accounting and funding system for military retirees. The Fund serves to pay for the costs of military retirement through a specific investment plan created by the Department of Defense Office of the Actuary, and is designed to function similar to private pension plans. The DoD is the first funding source, and pays for the normal cost of future retirements through an annual accrual payment identified as a normal cost percent of the basic pay appropriated each year by Congress for the pay and allowances of members of the armed forces on active duty and in the reserves. The second funding source, the U.S. Treasury, pays for the original unfunded liability through annual amortization payments. The Treasury's annual amortization payment is adjusted by any cumulative gains and losses to the Fund and then deposited into the Military Retirement Fund. In addition to these two sources, the Fund also receives as income the interest on the Treasury securities contained in its account. All three of the above sources of income are intra-governmental transfers, and the only outlays that count against the Federal Government are the actual outlays to military retirees and their survivors.

The Department of Defense Office of the Actuary supplies DoD with necessary dollar figures used by the defense department to budget for military retirement and the payment on the unfunded liability. A sophisticated computer model which incorporates the effects of numerous retirement benefits, decrement rates, DoD specific parameters and a broad range

of economic assumptions is used to calculate these necessary dollar figures.

The Defense Finance and Accounting Service is the accounting firm for DoD. This DoD agency is responsible for all the accounting, reporting, and managing of all General funds, Trust funds and other financial accounts. In particular, DFAS is responsible for managing retiree pay, the Survivor Benefit Plan, and the Military Retirement Fund. Officially established in 1990, DFAS has been tasked to consolidate and centralize DoD's retiree pay at the DFAS-Cleveland center and annuitant pay at the DFAS-Denver center.

Retiree and SBP annuities are paid from the Military Retirement Fund. Premiums for SBP costs are most often paid automatically by retirees through a payroll reduction method from their retired pay. SBP premiums paid from a servicemember's VA compensation, or from the service member directly are classified as direct remittances, and by law, are collected by DFAS and deposited into the U.S. Treasury instead of the Military Retirement Fund.

## **B. CONCLUSIONS**

The purpose of this thesis was to examine the total amount of SBP premiums that direct remittances represent and which are currently being deposited into the U.S. Treasury vice the Military Retirement Fund. Since its creation in FY 1985, the Military Retirement Fund has been subject to diversions which could threaten the actuarial integrity of the Fund. The Military Retirement Fund is currently responsible for paying outlays (annuities) to survivors of individuals whom never contributed a single dollar to the Fund's assets all because of the mandate within Title 10 requiring that their direct remittances be deposited instead into the U. S. Treasury. Consequently, millions of dollars in Plan premiums that

should be contributing to the asset value of the Military Retirement Fund are being used to fund other Government agencies and programs each year. In essence, DoD is subsidizing the funding of other Government agencies and programs each year due to these diversions from the Fund. Legislation should be initiated to change the federal statutes that permit direct remittances to be deposited into the U. S. Treasury vice the Fund.

The Board of Actuaries has the ability to adjust major parameters such as, the interest rate, Consumer Price Index or SBP election rates, and thus affect the normal cost percentages used to determine the actual contributions that must be paid by DoD into the Fund each year. The major valuation program parameters used in FY 1994 to calculate NCP's by the Office of the Actuary did not contain a parameter for direct remittances diverted to the Treasury. Since Survivor benefits is a component of the normal cost percentages, the NCP must therefore be understated. Consequently, the Office of the Actuary neglects to fully consider and account for this loss to the Military Retirement Fund.

The annual shortfall in millions of dollars to the Military Retirement Fund due to direct remittances being diverted to the Treasury have not affected the actuarial basis of the Fund, thus far. The current method and application in calculating normal cost percentages by the Office of the Actuary and the multi-billion dollar normal cost payment to the Fund by DoD have, so far, more than accounted for this small annual loss. It is unlikely the Military Retirement Fund will experience any future unfunded liabilities from the diversion of direct remittances. Yet, it does mean that DoD will continue to fund for millions of dollars in losses through higher normal cost payments than are necessary.

## **C. RECOMMENDATIONS**

To dismiss this loss to the Military Retirement Fund as being insignificant because of its relative size and impact on a multi-billion dollar trust fund is considered to be not within the guidelines of generally acceptable accounting practices for pension plans. By necessity, all DoD agencies must be extremely cost conscious, and concerned with accounting practices and funding shortfalls. Congress is always examining means to cut military retirement pay in an effort to reduce the national deficit. While the Survivor Benefit Plan is not a highly visible component of the Military Retirement Fund and funding process, the Department of Defense would best be served if DFAS-Washington (Headquarters), initiated a legislative change to modify the illogical mandates of U.S.C. Title 10 that apply to direct remittances and waivers in retired pay. As noted, DoD is contributing millions of dollars in unnecessary funds to the Military Retirement Fund each year, and because of this, DoD and ultimately U.S. taxpayers are paying more for a program than is necessary.

Survivor benefits is a component of the normal cost percentage. Normal cost percentages are used to determine the actual contributions paid to the Fund by DoD. It is the opinion of the author that the Office of the Actuary should develop a major valuation parameter that encompasses direct remittances diverted to the Treasury. This parameter should be used annually when calculating the normal cost percentages, and until the above recommended legislation is approved by Congress.



## APPENDIX. LEGISLATIVE HISTORY OF SBP

In a further effort to attain greater participation and interest in the Survivor Benefit Plan, additional liberalization of various provisions of the plan were enacted by Congress in a series of laws over the years. The following is a summary of those laws and is intended to provide both a reference and guide to the reader.

### Public Law (P.L.) 83-239 (8 August 1953)

Established the Uniform Services Contingency Act (USCOA).

- Elections made before 18th year of service.
- Annuities one-half, one-fourth, or one-eighth of retired pay; not adjusted for inflation. Annuities terminated upon remarriage of widow at any age.
- Covered only persons dependent on member of retirement.
- Premiums based upon age differences and continued for life, even if dependents died first.

### P.L. 87-381 (4 October 1961)

Changed name of program to Retired Serviceman's Family Protection Plan (RSFPP)

- Less than 15 percent of retirees participated.

### P.L. 89-365 (1966)

Provided for the alignment of the income tax treatment of RSFPP participation costs with that of the Civil Service survivor program by making the participating member's contributions tax exempt.

### P.L. 90-485 (1968)

- Participation elections allowed to become effective immediately, thereby deleting requirement to remain on active duty a minimum of three years after election.

P.L. 90-485 (Cont'd)

- Allowed member to change or revoke his/her election to participate between his/her 19th year of service.
- Changed the computation base for survivor's annuity to member's full retired pay at the time of retirement vice the member's retired pay as reduced by the member's participation cost.
- Survivor annuity amount was changed to allow a minimum of 12.5 percent to a maximum of 50 percent of the member's gross retired pay.

P.L. 92-425 (21 September 1972)

Established the Survivor Benefit Plan (SBP)

- Participation automatic for all retirees who retire on or after 21 September 1972 unless they decline participation prior to receipt of retired pay.
  - Annuities integrated with Social Security widow's benefits to provide survivor with up to 55 percent of retired pay. Under age 62, benefits provided by SBP; after age 62, benefits provided by a combination of SBP and Social Security widow's benefits. (Accomplished by reducing SBP benefits after age 62 dollar-for-dollar by the amount of SS widow benefits resulting from member's military earnings after 31 December 1956).
- (The military services began participating in Social Security 1 January 1957. Possible that annuities could be totally offset (eliminated) by entitlement to SS widow benefits).
- Annuities increased with cost-of-living adjustments (COLAs) at same time and same rate as retired pay.
  - Annuities reduced dollar-for-dollar by amount of entitlement to DIC benefits from VA.
  - Eligible beneficiaries included spouses and children, or persons having an insurable interest in retiree.
  - Premiums calculated under the formula: 2.5 percent of the first \$300 of base amount, plus 10 percent of remaining base amount. Base amount could be any amount between \$300 and full gross retired pay. Premium recalculated each year under this formula, thereby increasing the premium as a percentage of elected base amount (which also increased with COLAs).
  - Premium reductions in retired pay continued for life even if retiree's spouse died first.
  - Members who retired before 21 September 1972 permitted to enroll in SBP during an open-enrollment season between 21 September 1972 and 20 September 1973. RSFPP participants permitted to enroll in SBP in addition to



P.L. 92-425 (Cont'd)

RSFPP or to transfer from RSFPP to SBP.

- Surviving spouses of retirement-eligible service members who died on active duty automatically covered. Remarriage of surviving spouse before age 60 suspended benefits.
- Spouses acquired after retirement automatically covered under SBP after two years of marriage. No option to member to withdraw from program for new spouse.
- Minimum Income Widow benefits to surviving spouses of members who retired before 21 September 1972 and died before 21 September 1973 if widows also entitled to receive nonservice-connected death pensions from VA.
- Services required to notify spouses if members retiring after 21 September 1972 declined to participate or elected less than maximum coverage.

P.L. 93-155 (16 November 1973)

Open enrollment season extended to 20 March 1974.

P.L. 93-406 (2 September 1974)

SBP premium reductions in retired pay exempted from federal income taxes.

P.L. 94-496 (14 October 1976 - Effective 1 October 1976)

- SBP premium reductions in retired pay suspended if marriage ends in death or divorce.
- Waiting period for spouse acquired after retirement to become eligible to receive SBP benefits reduced to 1 year.
- Participation for children only permitted for married retirees.

P.L. 95-397 (30 September 1978)

- Eliminated SS offset (reduction in benefits at age 62) for widows while working beyond age 62.
- Restored SBP for widows who remarried after age 60 and lose DIC.
- COLA adjustments to RSFPP annuities paid to survivors of retirees who died before 20 March 1974.
- Continuation of RSFPP annuities to widows who remarry after age 60.
- Established Reserve Component - Survivor Benefit Plan (RC-SBP) to provide benefits to survivors of Reservists who are eligible to receive

P.L. 95-397 (Cont'd)

- retired pay but are under age 60.
- RC-SBP elections must be made within 90 days of receipt of Notices of Eligibility (NOE) to receive retired pay at age 60.
- Open enrollment season for Reservists who completed 20 years of Reserve service before 30 September 1978.
- Three participation options for Reservists in addition to regular beneficiary and participation levels which apply to SBP:
  - OPTION A - Make no election
  - OPTION B - Elect coverage for annuities to begin upon Reservist's death or upon date Reservist would have become age 60, whichever is later.
  - OPTION C - Elect coverage for annuities to begin upon Reservist's death, regardless of Reservist's age when death occurs.
- Premiums based upon age differences between Reservist and beneficiary at time of enrollment.
- Annuities reduced by actuarial factor to pay for coverage which is in effect before age 60.

P.L. 96-402 (9 October 1980)

- Eliminated application of premium computation formula each time retired pay increases with COLAs. Instead, premiums increase at same rate as COLA, thereby fixing premiums as a constant percentage of retired pay.
- Social Security offsets limited to 40 percent of a survivor's annuity, thereby eliminating possible total offset of annuity due to receipt of SS widow benefits.
- SBP premiums payable to "Forgotten Widows" -- widow of retirement eligible service members who died on active duty before SBP was enacted on 21 September 1972.
- Permitted withdrawal from SBP for retirees rated totally disabled by VA for 5 continuous years since retirement or for 10 continuous years beginning after retirement.

P.L. 97-35 (13 August 1981)

- Authorized open enrollment season to permit nonparticipants to take advantage of program improvements during the period 1 October 1981 - 30 September 1982.

P.L. 97-35 (Cont'd)

- Retirees participating at less than maximum level also permitted to increase previously elected coverage.
- Two-year survival period required for retirees before open season elections become valid. Premiums collected from retirees who died within two years of making elections refunded to designated beneficiaries.

P.L. 97-252 (8 September 1982)

Uniformed Services Former Spouses' Protection Act (USFSPA)

- Members who retire after 8 September 1982 permitted to (voluntarily) designate former spouses as insurable interest beneficiaries.

P.L. 97-253 (8 September 1982)

Extended eligibility period for Minimum Income Widow benefits to 20 March 1974 to coincide with the end of the extended original open season.

P.L. 98-94 (24 September 1983)

Permitted SBP participants who retired before 8 September 1982 to name former spouses as insurable interest beneficiaries during an open season between 24 September 1983 and 23 September 1984.

P.L. 98-525 (19 October 1984)

- Permitted former spouses to have SBP insurable interest elections deemed on their behalf if members agreed to name them as beneficiaries and agreement is included in a court order. Elections could not be ordered.
- Permitted payment of SBP benefits paid to spouses of missing retirees who are presumed dead (after being missing for at least 30 days and approved by SECNAV).
- Thurmond Amendment: Eliminated or reduced the Social Security offset to annuities paid to surviving spouses who are entitled to receive SS benefits based upon their own earnings records. (Repealed by P.L. 99-145 before it became effective.)

P.L. 99-145 (8 November 1985 - Effective 1 March 1986)

Established new "two-tier" method for computing SBP annuities for surviving spouses of members who became eligible for retirement on or after 1 October 1985.

- Annuities before survivor's age 62 calculated at 55 percent of elected base amount; annuities after survivor's age 62 calculated at 35 percent of elected base amount.
- Survivors of participants who retired or were eligible to retire before 1 October 1985 may have their annuities calculated under this method if it results in a higher annuity.
- Two-tier method of computing annuities also applied to annuities paid to disabled "children" who receive benefits beyond age 62.
- Eliminated Social Security offsets to annuities paid to widows with one child.
- Permitted payment of SBP annuities to children of retirement-eligible members who die in a common accident with their spouses.
- Requires spousal concurrence for any election to decline participation or for less than maximum coverage for a spouse. Requirement may be waived if spouse's location is unknown and provides evidence that reasonable efforts were expended to locate the spouse.
- Permitted coverage for former spouses under the spouse category (rather than as insurable interest beneficiaries). Retirees permitted to change previously elected insurable interest elections to spouse category with concurrence of former spouse during period 8 November 1985 - 8 November 1986.
- Children acquired during marriage to former spouse permitted to be added to former spouse elections under the spouse category.
- Low-cost portion of premium computation formula (referred to as "threshold") indexed to inflation at same rate as COLAs to active duty pay. (\$309 as of 1 March 1986).
- Permitted SBP participants who remarry after retirement the option to terminate participation during first year of remarriage. Also permitted participants with reduced base amounts to increase base amounts during first year of marriage (requires payment of higher premiums retroactive to original enrollment date).

P.L. 99-661 (14 November 1986)

- Reduced age at which remarriage suspends surviving spouse's eligibility to receive benefits to age 55.
- Eliminated reduction in benefits for disabled "children" annuitants at age 62.
- Empowers state courts to mandate SBP coverage for former spouses upon

P.L. 99-661 (Cont'd)

- divorce. Applies only to court orders issued on or after 14 November 1986.
- Permitted participants to add children to former spouse elections until 1 March 1987 (for members who elected former spouse coverage prior to 14 November 1986).
  - Permitted payment of SBP annuities to children of retirement-eligible service members who die on active duty if there is no surviving spouse or if surviving spouse subsequently dies. (Threshold amount \$318 effective 1 January 1987.)

P.L. 100-180 (4 December 1987)

Permitted retirees who had been participating in SBP with spouse coverage for a previous spouse and who remarried before remarriage termination options were enacted by P.L. 99-145 to withdraw from the program during the one-year period between 3 March 1988 and 2 March 1989. (Threshold amount \$324 effective 1 January 1988.)

P.L. 100-456 (29 September 1989)

Authorized payment of minimum SBP benefits to unremarried widows of retirement-eligible service members who died on active duty before 1 November 1953 (the effective date of original Contingency Option Act). (Threshold amount \$337 effective 1 January 1989)

P.L. 101-189 (29 November 1989)

- Revised method of computing SBP premiums to a flat 6.5 percent of a participant's elected base amount for all non-disability retirees who enter service on or after 1 March 1990. All service members who entered service before 1 March 1990 are grandfathered under two-part premium computation formula if it results in a lower premium.
- New 6.5 percent premium rate applied prospectively from 1 March 1990 to all existing SBP participants if it results in a lower premium.
- Disability retirees and Reservists are grandfathered indefinitely regardless of when they enter service.
- Enacted new Supplemental Survivor Benefit Plan (SSBP) to permit SBP participants to purchase additional coverage to eliminate reductions in survivors' post-age-62 benefits. Effective date 1 October 1991 (later extended to 1 April 1992). Additional premiums based upon member's age at time of enrollment.
- Authorized one-year open enrollment season between 1 October 1991 and 30 September 1992 during which all retirees may enroll in both SBP and SSBP

P.L. 101-189 (Cont'd)

(beginning date later extended to 1 April 1992). Two-year survival period required before open season elections become valid. Premiums refunded to survivors of participants who make new elections during open season but die before end of survival period.

- Permits payment of annuities to survivors of retirement-eligible service members who die on active duty, but who had not served in grade long enough to become entitled to retired pay for that grade, based upon the grade the member actually held at time of death. (Threshold amount \$349 effective 1 January 1990.)

P.L. 101-510 (5 November 1990)

Postponed effective date of SSBP and open season to 1 April 1992. (Threshold amount \$378 effective 1 January 1991.)

P.L. 102-190 (5 December 1991)

- Established four benefit levels under SSBP: 5 percent, 10 percent, 15 percent, or 20 percent of retired pay.
- Limits participation in SSBP to members participating in basic SBP at the maximum level.
- Permits DoD to charge additional premiums for open season elections.
- Established procedures to pay SBP annuities to mentally incompetent beneficiaries when no guardian has been appointed. (Threshold amount \$378 effective 1 January 1992.)

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